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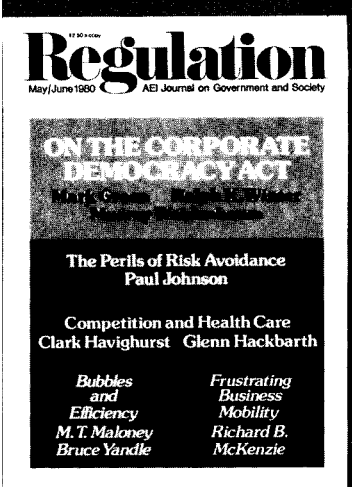

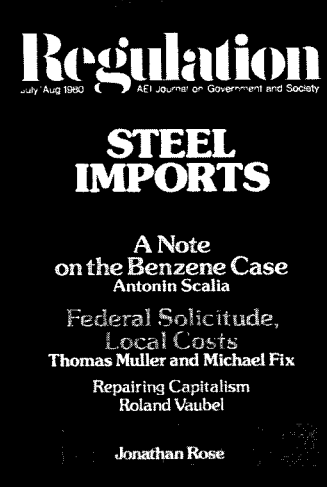

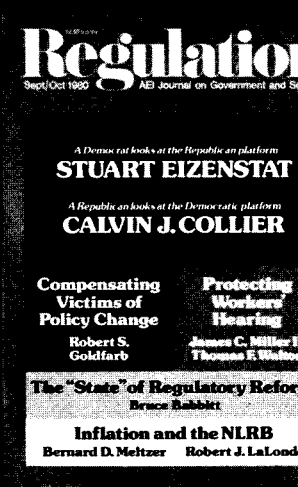
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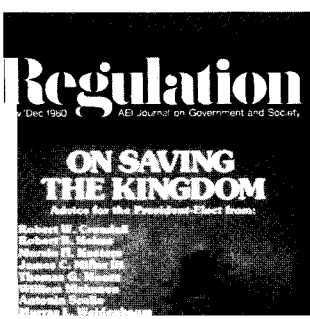

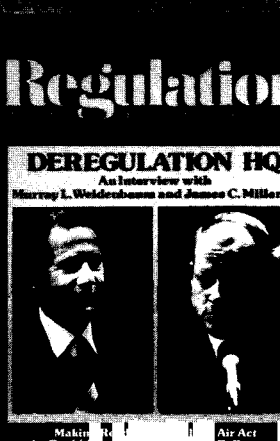

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Regulation

May/June 1981 AEI Journal on Government and Society

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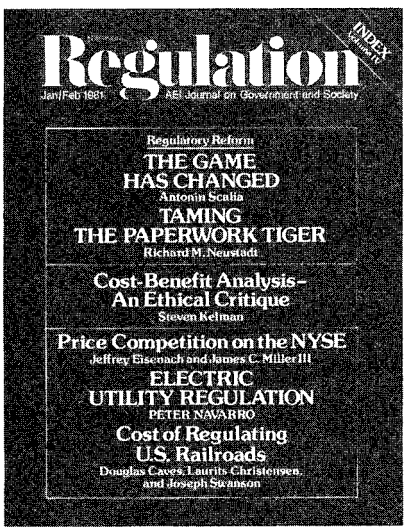
Letters

We welcome letters from readers, particularly commentaries that reflect upon or take issue with material we have published. The writer's name, affiliation, address, and telephone number should be included. Because of space limitations, letters are subject to abridgment.



The Morality of Cost-Benefit

TO THE EDITOR:

In "Cost-Benefit Analysis: An Ethical Critique" (*Regulation*, January-February), Steven Kelman elegantly savages a straw man—cost-benefit analysis as a necessary condition for public decisions about such matters as safety and health regulation. It is perhaps a timely savaging, for some important figures in the new administration use rhetoric that suggests the straw man looks real enough to them. Nonetheless, the position Kelman attacks would be defended by very few serious economists or policy makers. . . .

. . . What do we mean when we say things are "not for sale"? This may mean that the implicit price is either zero or infinite. Consider the difficulty with the former. For example, some in the conservation and sporting communities argue that access to wilderness or good trout fishing or white-water rafting should not be for sale. Traditionally these things have not been for sale; they have been free to all comers at zero price. If they cannot have a nonzero price how do we protect them from us? In practice we adopt all sorts of nonprice rationing schemes, including permit lotteries, monopolistic or oligopolistic franchises, and (in the sporting example) restrictions on techniques and kinds of equipment. Do we really believe that these expedients are morally preferable to other systems that might involve closer analogues to competitive markets?

Then consider things that have an "infinite price" or are "priceless." This is no doubt a useful rhetorical device, as Kelman points out. But that does not make it any more helpful as a guide to real decision making. It is never so simple as better red than dead or vice versa. We are not confronted with a referendum or a bill in the Congress that requires an infinite appropriation and guarantees "the survival and success of liberty." Rather we are asked whether we want to spend an extra $10 billion for this defense program; whether we want to cut or expand the foreign aid program; and what we think of energy independence in the form of massive synfuels development. In this context, the cost-benefit analyst may be seen as a humble dustman, scurrying around after the famous, trying to clean up the tangle of rhetorical flourishes littering the ceremonial fields.

Thus I do not think Kelman's analysis is very helpful in principle. A more practical reason for concern with his prescription is that cost-benefit analysis does exist and will be used by proponents and opponents of programs and policies whenever they think an advantage can be gained. The current enthusiasm for cost-benefit analysis by opponents of environmental and health and safety programs reflects their judgments about the balance that is likely to turn up, not their commitment to this tool as a necessary condition for public decisions. In the present condition of the field, they are likely to be right, since our skills in benefit estimation for environmental and health and safety programs are rudimentary, and the highly technical nature of much of the argument makes it easy for any given economist to criticize the estimates of any colleague. Enough demonstrations that costs swamp benefits or that there is no agreement on any benefit estimate will, especially in our gloomy economic climate, erode support for the special-thing or infinite-price arguments repeated by Kelman. When these bastions crumble there will be no fallback position and the retreat will be hard to stop. Even as a tactical matter, then, it behooves those of us who care about such things to try to advance the field rather than ignore or suppress it.

Clifford S. Russell,
Resources for the Future

TO THE EDITOR:

. . . After considering the interesting philosophical puzzlements posed by Steve Kelman's article, one is still left with a real and practical problem—what guidance are we to give those stewards of the public purse who make critical policy decisions? Are we to advise them not to use cost-benefit analysis? Instead of examining the potential consequences of their actions, should these analysts rely solely on their moral wisdom to determine such things as the proper wording on warning labels, the basis for requiring disclosures by used-car dealers, or the steps to be taken to reduce the incidence of cancer when carcinogenic chemicals are processed? While we might wish the wisdom of Abraham Lincoln for each of these analysts, we may doubt that such insight will emerge in sufficient abundance to preclude the need for a tool like cost-benefit analysis.

When decisions previously made by countless individuals on the basis of millions of market transactions are centralized, we face the impossible task of describing explicitly behavior which no one has written down. A decision to regulate carries with it a responsibility to account for regulatory actions. We move from a society formed by human action to one constructed by human design, a move that brings us to cost-benefit analysis.

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Thus, Kelman's concern with cost-benefit analysis or any other move toward constructivism may in fact be a concern with too much regulation. If so, his desire that less emphasis be placed on such techniques may be fulfilled as efforts are made to remove the blanket of regulation which covers so much human action. But some regulation will likely survive. And if so, will we leave the regulator to make private moral judgments, or will we ask for some description of how he has arrived at his choices?

Proponents of cost-benefit analysis do not generally recommend it as *the* decision device. Instead, they offer it as a tool to assist decision makers when they deal with the collective welfare of society. A cost-benefit analysis can generate useful public discussion, a conflict of ideas that may yield an improved decision. But perhaps even more important, it reserves society's moral judgments for issues of the most profound importance, such as whether or not to regulate in the first place.

Bruce Yandle,
Clemson University

STEVEN KELMAN responds:

I would like to respond both to these letters and to the four earlier replies to my article (*Regulation*, March/April). The thoughtful comments of my critics provide a basis, I hope, for a fruitful dialogue on regulatory decisions.

Let me start by noting where my critics and I *agree*. We agree that decisions about what levels of regulatory protection to require are difficult ones. We agree that consequences of decisions should be sketched out and analyzed systematically. We agree that explanations for decisions should be given, so that decision makers can be accountable for the balancing judgments they make.

I mention these areas of agreement partly because a number of those replying to me suggest that to criticize cost-benefit analysis is to attack the above propositions. If all that cost-benefit analysis did were to systematically sketch out the effects of regulatory alternatives and explain why a certain alternative was chosen, it would hardly be the powerful tool that "regulatory reformers" clearly believe it to be. EPA and OSHA, for example, have long carried out such analyses and explanations.

Honesty requires us to recognize that cost-benefit analysis implies more: It implies a rule ("maximize net benefits") that dictates, or very strongly suggests, *what decisions should be made at the end of the analysis*. It also requires, if the rule is to be applied, reducing costs and benefits to a common metric for purposes of comparison.

James DeLong is correct to note that I spoke of rights as an alternative to the "maximize net benefits" test as a justification for decisions. In this brief space, I can only suggest the outlines of an argument regarding the nature of rights. The notion of human rights rests, I think, on the suggestion that all people may legitimately make certain claims simply because they are human beings. The strength of a claim to a right is therefore based on the strength of its connection to the maintenance of human life, human dignity, or the elements of our common humanity (such as the ability to reason) that make humans unique among forms of life. Since this basis of claims to human rights is something we all share equally, there is also an egalitarian thrust to the notion.

Proponents of cost-benefit analysis offer an entirely different test for the strength of a claim: They ask whether the cost of meeting the claim is greater than the claimant's willingness to pay for it. But rights such as those to freedom of speech are granted on the former basis, not the latter, which is why we do not do cost-benefit analyses of the Bill of Rights. Costs, and the willingness to pay of various parties, are part of any moral deliberation, but far from the *only* factors. There is where I profoundly differ from cost-benefit advocates.

On the issue of the common metric, Clifford Russell asks whether I believe that refusing to place a dollar price on non-market things really is "morally preferable to other systems that might involve closer analogues to competitive markets." I do indeed, in many cases. My reasons are developed in part in my article and at greater length in my forthcoming book, *What Price Incentives? Thoughts on Economists and the Environment*. The very process of monetizing many non-priced benefits has great costs. In some instances these costs include moral costs, because the values diminished may be those of human life or human dignity, the basic units of ethical discourse. If I thought that the benefits of such monetization were overwhelming, I might justify the practice. But I do not think they are.

James DeLong notes that "I may specially value a family relationship, but how often I phone is influenced by long-distance rates." I must confess that my reaction is: "So what?" If he means to suggest that we should put dollar values on family relationships, then he ought to make this argument explicitly. He doesn't, and therefore I fail to see the significance of his point.

Robert Solow notes that using units of measurement other than dollars might reduce the costs of monetizing non-market things. This is an interesting point. But all except one of the arguments my article makes against monetizing non-market benefits would hold just as well if the accounting unit were doughnuts. Only my last argument —that the process of pricing can itself diminish the perceived value of the previously non-priced thing—is partly dependent on dollars as the unit of account. I believe that part of this decrease comes from the very fungibility of *any* standard unit of account. Many years ago, Emile Durkheim argued that the very nature of sacredness is that we do not treat the sacred thing in ways that we treat the normal run of things. I also believe that if some unit of account other than dollars were invented for use in cost-benefit analysis, similar problems would soon attach to this new unit.

Finally, a number of my critics suggest that I attacked a "straw man." Much of Solow's reply, for example, argued not so much against points I made as against the idea that any serious advocate of cost-benefit analysis would suggest a simple decision rule of maximizing net benefits.

I urge Solow to look at cost-benefit analyses economists have done, say of OSHA regulations, in search of the kind of recognitions he says all serious practitioners accept. President Reagan's executive order states that regulation "shall not be undertaken unless the potential benefits to society for the regulation outweigh the potential costs to society" and that "[r]egulatory objectives shall be chosen to maximize the net benefits to society." The "straw man" does indeed seem real.

If my comments serve to chasten cost-benefit enthusiasts about the ethical implications of methods they appear to feel are mere "neutral science," I believe I will have achieved an important purpose.

(Continued on page 59)

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Perspectives
on current developments

Locking the Rascals in

Why hold elections? To let the voters throw the rascals out, as the saying goes, or—more soberly formulated—to let the voters change government policy. Yet depending on the outcome of a case now in the federal courts, it may soon become all but impossible for the voters to remove most policy-making federal officials —even if they are not covered by civil service protection.

The case involves the Federal Emergency Management Agency, which coordinates federal aid efforts in natural disasters, but it could as easily have arisen at almost any agency. Two days after President Reagan's inaugural, the agency's new acting director asked for the resignations of the nine regional directors he had inherited from the Carter administration. The regional directors held so-called Schedule C positions under the Civil Service Act, which means that they served at the pleasure of the President. All nine duly resigned. But then, for the first time in any presidential transition, four of them immediately filed suit in federal court to get their jobs back, claiming that it violated the First Amendment for the new administration to dismiss them because of their political beliefs—which is to say, their membership in the party defeated in the election.

Such a suit would have been unimaginable until 1976, when the Supreme Court decided *Elrod* v. *Burns*. That case arose in the very mother lode of patronage politics, Cook County, Illinois, where Democrat Richard Elrod had replaced an incumbent Republican sheriff. By statute, about half the department's employees were protected by civil service, with the rest being subject to dismissal by the new sheriff. Four Republican employees, sacked for want of Democratic sponsorship, challenged their firings in court.

A majority of the Supreme Court, although divided in its reasoning, took their side. The Court found that it violated the employees' First Amendment rights to fire them because they were Republicans. (Never mind that, as the dissent pointed out, they also seemed to have been *hired* because they were Republicans.) Three justices concluded flatly that non-policy-making personnel could not be fired for partisan reasons. Two other justices maintained that employees with confidential duties should not share in the protection.

The Court broadened that protection last year in *Branti* v. *Finkel*. The county legislature of Rockland County, New York, elects a public defender for a term of six years. In 1978 a Democrat defeated the Republican incumbent and promptly fired two Republican assistants. The two lawyers went to court.

The Supreme Court held that they had to be reinstated. This time six justices agreed on a rationale, though not the same one used in the Cook County case. Justice Stevens, speaking for the Court, said that the new test would be "whether the hiring authority can demonstrate that party affiliation is an appropriate requirement for the effective performance of the public office involved." Under this rule, he noted, even some policy-making employees might be protected against discharge.

Among the dissenters, Justice Stewart insisted that the attorneys were confidential employees and entitled to no protection, while Justice Powell warned that the new standard was "vague" and "overbroad." The haziness of the "appropriate requirement" standard, indeed, seems likely to lead to a long procession of case-by-case determinations for myriad governmental offices.

It is scant wonder that the Court cannot divine the precise scope of a constitutionally mandated civil service, since that institution is not to be found in our constitutional tradition, but is entirely of the Court's own creation. During the 185 years before *Elrod* v. *Burns*, governments had been allowed to select their own

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blends of spoils and civil service, and practices differed widely. It speaks well of the majority justices' capacity for growth and change that in the period since their respective appointments to the Court—appointments for which party affiliation was surely the first qualification—they came to realize the incompatibility of partisan selection with our fundamental social beliefs. (As Justice Powell suggests, the Court's reasoning in prohibiting partisan dismissal extends to partisan appointment as well.) But the timing of this new discovery is surely surprising. One would have expected it in the heyday of enthusiasm for the civil service system. That enthusiasm has given way in recent years to a more balanced view. A spoils system allows voters the fullest control of government, makes elected officials completely responsible for the actions of their underlings, and strengthens political parties; on the other hand, it can produce coercion of political belief and outright corruption. Civil service develops a pool of neutral government expertise, provides continuity, and may encourage more public spiritedness among politicians, since there is less booty for them to distribute; on the other hand, it eliminates one of the few built-in incentives for dismissing inefficient public employees, reduces participation in political party affairs, and abets the growth of entrenched and unresponsive bureaucracy.

The popular feeling of "government by bureaucracy"—and perhaps the reality of such a government—would likely be enhanced by a judicial decision in the *FEMA* case extending *Elrod* and *Branti* to federal employment. There is a conceivable basis for coming out differently: as the Court noted in *Elrod*, the so-called political question doctrine (excluding the Court from matters committed by the Constitution to other branches), and the doctrine of separation of powers, could not be invoked in the state cases. It is possible, then, that the Court's constitution-making in this area will yield a result similar to that of its venture into legislative apportionment, imposing upon the states a restriction not applicable to the federal government itself. (The states, according to the Court's ruling in *Reynolds* v. *Sims*, may not constitutionally have bicameral legislatures with one house apportioned by geography rather than population—though the United States Senate is O.K.) One should hope not. This is one of those situations in which worse is better. The extension of the Court's constitutionalized civil service (whatever its vague content may be) into the federal realm provides the best hope that it may reverse its earlier decisions—or find them reversed by constitutional amendment. Indeed, we hope the *FEMA* case is soon followed by the *Elrod* equivalent of *Davis* v. *Passman*—in which a *congressional* employee asserts a constitutional right not to be fired.

Less Paperwork for Generic Drugs?

In many ways the latest controversy at the Food and Drug Administration seems quite familiar. On one side are Carter administration regulators and Ralph Nader groups, and on the other Reagan administration deregulators and large, profitable drug companies. One side argues for regulation on grounds of basic fairness and equity, and because progress in health care and even human lives may be at stake. The other side maintains that regulation would impose a large and quite unnecessary compliance burden on private business and drive up both consumer prices and federal spending, all for benefits that are nebulous at best.

This time, however, there is a new wrinkle. The starry-eyed idealists demanding regulation are the large corporations. And the hard-nosed skeptics brandishing pocket calculators are the "public interest" groups.

The point at issue is whether the agency will permit makers of low-cost generic drugs to market their products without lengthy testing. This would be the effect of a policy adopted by the Carter administration during its closing weeks, pulled back on February 10 by incoming Health and Human Services Secretary Richard Schweiker, and then reinstated by Schweiker on April 16. The policy would allow generic drug makers to cite previously published medical research in their new drug applications (NDAs) instead of requiring them to carry out their own clinical tests of safety and effectiveness. According to the generic firms, such tests would represent pure regulatory waste, since they would tell the FDA nothing it did not already know.

But to firms in the business of inventing and patenting new drugs, the "paper" NDA seems manifestly unfair. A company that in-

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vents a new drug, they point out, must spend $70 million on the average to market it, much of which goes toward proving its safety and effectiveness to the FDA. A generic imitator who can get a free ride on this research can undercut the pioneer firm's price when the latter's patent expires. Worst of all, getting the original approval from the FDA can take from seven to ten years of the seventeen-year patent term. If the generic imitator could short-circuit this lengthy approval process, the originating firm might have only a few years of sole production—barely enough to build up a market—before competition comes in. With their potential profit from inventions cut short in this way, the pioneer firms say, they would have less of an incentive to embark on the risky and arduous process of new drug development. The result would be fewer new lifesaving drugs. A disturbing side effect is that pioneering firms might refuse to publish the results of their clinical tests for fear they would be used by generic applicants.

The proponents of "paper" approval have some strong arguments of their own. According to Mark Novitch of the FDA, the expense of compiling new test data from scratch would be enough to keep generics out of all but the most "tremendous" markets for drugs coming off patent. Since the prices of generics are often as much as 30 to 50 percent below those of branded drugs, that would impose heavy costs on drug consumers (including the federal government, which now pays for a fair proportion of all prescription drugs). The Federal Trade Commission's Bureau of Economics has estimated that from $444 to $817 million a year could be saved by full substitution of generics.

If generic firms are compelled to conduct original testing, they will have to run tests on human patients, some of whom will be placed in control groups that receive placebos or treatments less effective than the drug being tested. While the FDA is authorized to waive placebo testing in extreme situations, any unnecessary testing involving sick patients would raise ethical questions. In addition, requiring generic firms to conduct full testing is a very odd way to compensate inventors. For most drugs, if the rule keeps generics out, it would amount to an infinite (or at least indefinite) patent—hardly a defensible idea. For those drugs important enough to attract generics in spite of the rule, it would afford little protection other than imposing the usual regulatory delay upon new en-

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"The chef's salad is beautifully prepared and finely seasoned. The generic salad contains the same ingredients simply thrown on the plate."

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trants. Thus the scheme would overcompensate most inventors, the exception being those who invent the most valuable substances.

The reader may wonder why, since branded prescription drugs and generic copies have been around for a long time, paper NDAs have only recently become a regulatory issue. The answer is that we are now seeing a delayed effect of the famous Kefauver amendments of 1962, which required drug applicants to prove effectiveness as well as safety and which greatly increased the cost of filing NDAs. Only in the past few years have patents begun expiring on the post-1962 drugs on whose NDAs millions of dollars apiece were expended by the pioneer companies. The "free rider" issue is thus coming up now for the first time.

When the FDA approved the first paper NDA in 1979, research drug firms sued to prevent any further approvals on grounds that the FDA had adopted the policy without a public hearing or formal rulemaking. The judge advised the plaintiffs to petition the FDA for redress before running to court with their complaint. The agency rejected their petition on December 12 of last year, still without a hearing or rulemaking. There were new lawsuits. On February 10 incoming Secretary Schweiker postponed adoption of the policy for purposes of review and because of the continuing litigation. There were reasons for caution. The FDA had rejected the manufacturers' petition during the "midnight" transition period; in addition, approving a batch of generics would be an irrevocable decision, while staying the policy would only postpone its benefits temporarily. Still, Schweiker came under ferocious attack from Rep. Albert Gore (Democrat, Tennessee) of the House Commerce Committee, and on April 16 he agreed to let the policy go through. The FDA reportedly intends to use paper NDAs only as an interim measure, however, while it prepares a more comprehensive policy on post-1962 drugs.

No one on the one side of the controversy can reasonably deny that paper NDAs would save consumers money on existing drugs, and no one on the other side can reasonably deny that they would lower the incentive to discover lifesaving drugs. So the question is: should a chance to save lives, however minute, outweigh a chance to save money, however enormous? The "public interest" groups would probably avoid putting it in those terms. But they should not apologize for their position; it is quite a respectable one.

In approving the paper NDA policy, Schweiker endorsed an idea that may offer a way out of their dilemma: extending the life of drug patents beyond the seventeen years set by current law. One such bill, introduced by Senator Charles Mathias (Republican, Maryland), would extend such patents to cover up to seven years of regulatory delay, thus guaranteeing most inventors about the same basic period of sole production. Such a solution would still give the generic manufacturer the "free ride" on the inventor's testing costs, but at least the inventor would have something closer to the full seventeen-year patent term to recoup those costs.

Much A-Brew about Nothing

" 'Tis no sin for a man to labor in his vocation," observed Shakespeare's Sir John Falstaff. His corporate namesake, the Falstaff Brewing Corporation, has been seeking to uphold this maxim in a year-long fight with Nebraska's liquor regulators. At issue is Falstaff's right to sell private label beer from its Omaha brewery to Nebraska supermarket chains. According to the Nebraska Liquor Control Commission, the brewery's production of Scotch Buy beer exclusively for Safeway supermarkets violates a state law forbidding brewers from giving "anything of value" to retailers.

The controversy began in April of last year, when the state attorney general's office filed a complaint with the commission against Falstaff and two grocery chains, Safeway and Hinky Dinky. Hinky Dinky was apparently wishy-washy, and went quietly, agreeing in January to drop its private label brew. But Falstaff and Safeway, while allowing the factual basis of the charge ("I will answer it straight," said Sir John. "I have done all this. That is now answered"), denied that anything of value had been given. Safeway, after all, had paid for its beer just like anyone else, and even sold it at a discount.

No matter, said the attorney general's office. The state law was designed to guarantee equality among retailers, and what could be

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more unequal than an exclusive brand? Falstaff should either make Scotch Buy available to all comers on the same terms or stop producing it, a state official said. Furthermore, to quote the *Omaha World-Herald*'s summary of the official's position, "companies like Safeway are so large and financially sound that they can afford to sell their own private brands, thus giving them an unfair competitive edge over smaller merchants."

It is doubtful that the jovial Sir John himself thought economies of scale unfair, either in men or in beer. As to the latter, he took the principled consumerist view: the more and the cheaper, the better, thought he. He also had a more subtle understanding of brand loyalty than the Nebraska attorney general: "I would to God thou and I knew where a commodity of good names were to be bought." He even had a few words of warning appropriate for legislators who try to guarantee equality among unequal competitors: "Thou art essentially mad, without seeming so."

The corporate Falstaff, like that of the plays, was not one to suffer indignity quietly. The firm's chairman took out a full-page newspaper ad offering $25,000 to anyone who could prove that private label beer was illegal in any other state. He scored local officials for their lukewarm support of his cause ("Call you this backing? A plague upon such backing!"). And he spurned attempts in the state legislature to declare the beer legal, preferring to seek vindication in the courts (" 'Tis no matter; honor pricks me on").

The dispute came to a head, so to speak, on March 20, when Falstaff announced that it would stop making beer at its Omaha brewery, explaining that it no longer felt welcome in the state. Workers and their families marched on City Hall on behalf of the company. Editorials expressed support. Politicians roused themselves from their torpor and began viewing with concern, noting with alarm, and seeing light at the end of tunnels. Some even took the more pragmatic (and not entirely unpleasant) step of flying from Nebraska to San Francisco to confer with brewery officials.

All of which was of no avail before the stern and incorruptible jurists of the Liquor Control Commission. Their two-to-one verdict, rendered April 2, found Falstaff guilty as charged and ordered it to abandon its arrangement with Safeway ("Truly, mine Host, I must turn away some of my followers"). In particular, the commission declared that "the word 'give' found within Neb. Rev. Stat. SS. 53-168 (2) (Reissue 1978) is susceptible to a broader definition than to mean only 'gift' " ("Have I lived to stand at the taunt of one who makes fritters of English?") and "can and hereby is taken to mean 'deliver, furnish, transfer, provide, and/or sell.' " ("O, thou hast damnable iteration!")

If it is illegal for Falstaff not only to *give* Safeway anything of value, but even to *sell* it such a thing, one wonders how any brand of beer at all is to change hands. Is Nebraska going Dry?

The Falstaff affair seems to have ended happily, however. The state legislature moved quickly to make private label beer legal again, and the company relented on its threat to close the Omaha brewery. We think Sir John would have drunk to that.

Grass-Roots Lobbying: Propaganda Non Grata

These have been frustrating times for hunters of that wily and fleet-footed creature, the grass-roots lobbyist. Pursued by baying regulators, blunderbussed by congressional critics, beleaguered grass-rootsers have kept right on voicing opinions, discussing legislation, and even dissenting from government policy. And if a last-ditch attack by the Internal Revenue Service is turned back, they will soon be able to work the grass roots with near impunity.

Grass-roots lobbying is the practice of seeking to influence legislation, not by approaching legislators directly, but by urging fellow citizens to do so. In its purest form it employs mass mailings or newspaper ads to induce voters to send ready-made postcards or clip-along-dotted-line forms to their representatives. The controversy over grass-roots lobbying extends, however, to a far greater range of activities, including speeches, phone calls, and publications of all sorts.

According to its critics, grass-roots lobbying poses two dangers. The first is that legislators may be unable to tell the artificial cards and letters instigated by the grass-roots lobby-

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ist from the genuine cards and letters arising from spontaneous public opinion. The second is that those who have the financial means to broadcast their opinions widely will "drown out" those who are less well off. Whether by mimicking genuine opinion or by competing with it, on this view, the grass-roots lobbyist is in effect poaching on the preserve of public opinion.

There is no lack of would-be gamekeepers, but their efforts have mostly come to grief. Several years ago, for instance, former Senator Thomas McIntyre (Democrat, New Hampshire) and others asked the Federal Trade Commission to investigate the "idea advertising" of Mobil and other oil companies for possible deceptive statements. The FTC begged off, citing the First Amendment. Massachusetts passed a law forbidding corporations from speaking out on referendum issues. The Supreme Court struck the law down in its 1978 *Bellotti* decision, citing the First Amendment. New York prohibited utilities from venting controversial opinions through paid advertisements or through inserts in customer bills. The Supreme Court struck both prohibitions down last year, citing the First Amendment. Senator Lawton Chiles (Democrat, Florida) introduced a law requiring disclosure and record-keeping by grass-roots lobbyists. Editorialists around the nation cried fie, citing the First Amendment, and the bill failed to pass. The Securities and Exchange Commission even got into the act last September when one of its staff reports proposed mandatory disclosure of corporate grass-roots advocacy. That proposal was quietly shelved after the election.

Only one agency is still out on the trail: the Internal Revenue Service. On November 25, IRS proposed stiff new rules that would greatly widen the definition of nondeductible grass-roots lobbying and would increase tax and accounting burdens on businesses, associations, and foundations that engage in public advocacy. Businesses have long been unable to deduct the cost of their efforts either to influence public opinion on legislation or, in most cases, to influence legislation directly. (Appearances before legislative bodies and contact with their "own" representatives are exceptions.) The new IRS rules, however, go far beyond previous practice. Trade associations would have to compute the proportion of their outlays spent on nondeductible grass-roots advocacy, and their members would not be able to claim a business deduction for that proportion of their membership dues. In addition, in what an American Bar Association committee called a "major departure from past administrative practice," the IRS would scrap the "substantiality" test whereby grass-roots lobbying is ignored if it represents only a small part of an association's activity. And IRS would for the first time require associations and firms to compute the indirect costs of grass-roots efforts, including an appropriate percentage of clerical salaries, utilities, and rent. These too would be nondeductible.

Under the new regime, an advertisement would be wholly nondeductible if even a small portion of it contained an implicit opinion on legislation. And the test of "implicit opinion" would be stringent indeed. A legislative analysis universally agreed to be fair and impartial, for instance, would be considered implicitly partial for tax purposes if a business sent it out to an audience which it could reasonably predict would favor one side of the issue. A topic could be considered legislative, moreover, even if no legislation on the subject were proposed, had ever been proposed, or were remotely likely to be proposed. An environmentalist foundation that mused in its magazine that America would be a nicer place if there were no more cars could not plead that no bill was pending to outlaw cars; it would be sufficient that its wish could not be fulfilled without an act of Congress.

The regulations would apply to just about all forms of communication not strictly limited to an in-house audience. A trade association could discuss legislation in a newsletter to its members, but would be in trouble if it sent copies to public libraries or the press. An executive speaking to a civic group might face tax consequences if legislative matters came up during a question-and-answer session. An otherwise deductible advertisement would be disallowed if it invited readers to write for further information and the information included opinions on legislation. Aside from a narrow exemption for material sent to the scientific and academic community, almost all communications would be potentially suspect.

Not surprisingly, the IRS has been inundated with comments, ranging from polite con-

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cern to outrage. Trade associations and their members have led the charge; some argue that the rules' complex accounting requirements would be even more burdensome than the added taxes. Other opposition has come from foundations and labor unions, as well as from newspapers and broadcasters fearful that the costs of preparing editorials might be disallowed. The American Bar Association committee on taxation says that the rules would "have a 'chilling effect' on the exercise of the constitutionally guaranteed right of free speech" and would "tend to restrict the free exercise of institutional political speech at a time when the exercise of such speech is gaining increased recognition." The ABA committee also finds the proposed definition of a grass-roots communication "unduly broad and subjective."

On the other side are groups such as Common Cause, which asserts that if the guidelines were narrower the government would be subsidizing corporate speech. All that the rules would do, these groups maintain, is force corporations to pay for their own propaganda. But while deductibility of expenses in individual income taxes may arguably reflect some sort of special favor by the government, deductibility in corporate income taxes surely reflects no such thing. There, deductibility is the rule rather than the exception, since the object of the corporate income tax is to capture a share of the funds distributed to, or saved on behalf of, the stockholders. Generally speaking, all the money the firm spends to further its business interests is deductible. If corporate deductibility is a subsidy, therefore, the government is massively subsidizing every business, and the only way to end subsidies would be to apply the 46 percent corporate tax rate to a firm's sales instead of its net profits.

The Internal Revenue Code's treatment of grass-roots advocacy is at any rate not primarily motivated by abstract questions of tax equity. In the view of the leading congressional voice on the matter, Representative Benjamin Rosenthal (Democrat, New York), "Congress enacted the grass-roots lobbying provisions of the Tax Code because it wished to discourage powerful economic interests from dominating public debate on legislative matters." That is to say, Congress wanted not merely to "chill" but actively to hinder corporate speech, basing its action on the "drowning out" argument.

The Supreme Court said in its *Bellotti* decision that the "drowning out" rationale for suppressing corporate speech is "wholly alien to the First Amendment." It seems unlikely, however, that the Court would strike down the mere denial of a deduction (as opposed to an absolute prohibition of the sort involved in *Bellotti*) on this basis: In 1970, in *U.S. v. Consumers Power*, it declined an opportunity to do so, letting stand a lower court decision that disallowed a deduction for an advocacy ad. On the other hand, the Court ruled in its 1974 *Big Mama Rag* decision that a tax provision can violate the First Amendment if it is so vague as to invite politically motivated enforcement. The Tax Code's provision on lobbying and its implementing regulations must give concern on this score.

A curious sidelight to the grass-roots lobbying issue is that the federal government itself, according to the General Accounting Office, conducts extensive grass-roots lobbying with taxpayer funds. Such activity is of course prohibited by statute, for the distinctive reason that some people's money should not be used to support other people's politics. Nonetheless, last year GAO turned up evidence that the Interior Department's Office of Surface Mining carried out a coordinated grass-roots campaign to defeat a bill that would have turned much of the agency's power over to state governments. Congressional investigators uncovered internal memos detailing how agency employees organized a lobbying coalition of private groups, generated home-state mail, and even drew up plans to juggle grant announcements to affect wavering members of Congress. And turning to more recent issues: On May 1, GAO reported that the Legal Services Corporation had "engaged in and allowed its grant recipients to engage in lobbying activities prohibited by Federal law" in attempting to defeat proposed cuts in its budget.

One step that the new administration could take to remedy what may be widespread abuse is to issue government-wide guidelines implementing the law against agency lobbying —so as to clarify the line between informing the public and lobbying it. Even with such a measure, however, the line would remain less than sharp; and even assuming no violation of the law by the agencies, the federal government's ability to mobilize public opinion would

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remain substantial. That is all the more reason to be cautious in closing off potentially effective countermeasures from the private sector, as the new IRS rules would do. Even taking the view that the nondeductibility rule for corporate lobbying is necessary and appropriate to prevent the "drowning out" of other public debate, the law surely should not adopt a definition of lobbying that is so unrealistic or impose record-keeping and accounting costs that are so high as to dry up this element of the debate entirely.

The IRS rules should go back to the drawing board. Incidentally, IRS rules are covered by the new executive order requiring cost-benefit analysis and OMB clearance—but are not covered by proposals pending on Capitol Hill to put some parts of the executive order into law. IRS rulemaking has traditionally enjoyed a sort of sacrosanctity: most of it is not technically subject to the notice-and-comment procedures of the Administrative Procedure Act because it is merely "interpretative" of the law, and it is generally given a wide berth by executive branch managers because it is so technical and seems to be merely routine law enforcement. The grass-roots lobbying rules—like the IRS proposal last year that would have subjected private schools to onerous antidiscrimination requirements in order to qualify for the charitable deduction—demonstrate that such sacrosanctity is a great luxury. The power to make tax rules, it appears, involves the power to destroy.

Reversing the D.C. Circuit at the FCC

The Supreme Court's March 24 decision in *FCC* v. *WNCN Listeners' Guild* marks the end of an extraordinary dispute between the U.S. Court of Appeals for the District of Columbia and the Federal Communications Commission. It may also mark the beginning of a new era in the relationship between the regulatory agencies and that court.

The dispute involves the FCC's ongoing effort to give radio station owners more latitude in deciding what programming to broadcast (see Perspectives, *Regulation,* March/April 1981). The specific point of controversy first arose back in 1970, in *Citizens' Committee to Preserve the Voice of the Arts in Atlanta* v. *FCC.* The owner of two stations in Atlanta had applied to the FCC for permission to sell the stations to a new owner, who planned to change their programming format from classical to semiclassical and popular music. Despite challenges by various groups, the commission granted the application without a hearing. It found that the transfer would be in the public interest because, among other things, the existing format was unprofitable for the stations, another Atlanta station broadcast classical music during the day, and community attitudes generally favored the format change. No hearing was necessary, it said, because the statutory prerequisite of a "substantial and material question of fact" did not exist. The D.C. circuit reversed the commission, holding that a hearing was required.

The startling part of the court's decision was not its finding that there existed, as to the format issue, "questions of fact" that were "substantial" (which certainly seemed to be the case); but rather its determination that those questions were "material" to the FCC's decision concerning transfer approval. For while the commission had, over the years, never brought itself to uttering the dread regulatory heresy that entertainment format (short of obscenity or indecency) was simply none of its business, it had in fact behaved in that fashion —requiring that program format be specified in applications for license grants, renewals, and transfers, but never denying an application on the ground that the proposed format would not serve the public interest, so long as it could find that the format had substantial public support. (Of course the latter finding could always be made since, in selecting its format, the applicant was, to put it mildly, hardly indifferent to public appeal.)

In the Atlanta case, the court was suggesting that this was not enough and that the commission had a positive responsibility to ensure that the stations in a community serve all significant programming tastes that can feasibly be served. "[I]t is surely in the public interest," the court said, "as that was conceived of by a Congress representative of all the people, for all major aspects of contemporary culture to be accommodated by the commonly owned resources whenever that is technically and economically feasible." And lest it be thought that

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In Brief–

Non-Carcinogen of the Month. The Food and Drug Administration is quick to accept the results of animal tests when they suggest a hazard. One wonders, therefore, what they will make of a new report by researchers at the Oak Ridge National Laboratory. It shows that a food additive, butylated hydroxytoluene (BHT), has a significant effect on the health of laboratory mice—for the better. Mice fed a high dosage of BHT lived more than 25 percent longer on average than mice who went without it, according to the researchers' report in the July 1979 *Journal of Gerontology*. Moreover, the researchers observed that "throughout most of their life span, BHT-treated mice were generally heavier, their hair coats were much smoother, and they were healthier in appearance." The health-conscious reader will be glad to learn that BHT is widely used as a preservative in cereals, pastries, breads, and many other common foods.

Crimestopper's Notebook. The Reagan administration proposed on May 5 to legalize a social abomination that enlightened government has spent nearly forty years trying to suppress. Hardened addicts of the vice, often quite elderly, can be identified by the needles they carry and the wicker baskets, often cleverly disguised as fruit bowls or bird nests, in which they conceal their contraband.

The offense in question is knitting—to be exact, knitting at home for pay in defiance of federal labor regulations. Since the 1940s, "homework" has been illegal in seven needle trades, one reason being that it is notoriously difficult to enter people's living rooms to enforce wage-and-hour and labor relations laws (and, more recently, OSHA regulations). Even more to the point, garment unions and major apparel manufacturers do not want the competition. They warn that once workers get a taste of home knitting they will move on to stronger stuff, like embroidering handkerchiefs and tatting little doilies. And where will it all end?

WHO's Minding the Store. During the debate over the World Health Organization's infant formula marketing code, some U.S. officials warned that the code would lead to other types of regulation by the United Nations and its affiliates: an "international FTC," in the words of Health and Human Services Secretary Richard Schweiker. Others dismissed these concerns as alarmist. Now the director general of WHO, Dr. Halfdan Mahler, has told Schweiker (according to the Pharmaceutical Manufacturers Association newsletter) that his office has budgeted funds for the drawing up of an international pharmaceutical marketing code.

At the same time, the director general of the United Nations Educational, Scientific, and Cultural Organization is drafting specific proposals for the planned New World Information Order, to be brought up at the next UNESCO meeting in 1983. If these projects are brought to completion, there may be an "international FDA" and an "international FCC" to go along with the "international FTC."

Paternalism Tiptoes on. Who says the Consumer Product Safety Commission serves no useful function? On April 3 a nonprofit group asked the commission to set standards for shoes, particularly women's shoes, whose "inadequacies in sizing, shape, and/or construction" endanger the podiatric well-being of hapless American consumers. The Community Health Information Council's petition suggested that the agency require a warning label on offending shoes. There is a simpler approach: if the shoe doesn't fit, don't wear it.

by "culture" the D.C. circuit meant only classical music and the arts, it later ordered the commission to hold a format-change hearing in a case entitled *Citizens' Committee to Keep Progressive Rock* v. *FCC* (1973).

The commission was less than zealous in complying with the court's mandate, even with respect to the narrow requirement that it hold hearings in such cases. (With some reason: in many cases the mere prospect of an expensive hearing is enough to quash a station sale.) And it was downright obstinate in refusing to accept the underlying affirmative responsibility to ensure diversity in entertainment programming.

The issue came to the first of several climaxes in 1974, with the D.C. circuit's decision in *Citizens' Committee to Save WEFM* v. *FCC*. There not only had the commission refused to order a hearing in a format-change license transfer on the usual ground of no substantial factual dispute, but also, to add insult to injury, six of the seven commissioners had joined in a separate opinion defending the commission's past policy of leaving entertainment programming to market forces. Well, you can imagine how mad that made the D.C. circuit! Sitting in its full assembly of ten judges instead of in the usual three-judge panel, the court once again reversed the FCC and required a hearing; and then, noting "this court's role as the sole forum for appeals from FCC licensing decisions," it went on to say:

> We think it axiomatic that preservation of a format [that] would otherwise disap-

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> pear, although economically and technologically viable and preferred by a significant number of listeners, is generally in the public interest . . . [A] policy of mechanistic deference to "competition" in entertainment program format will not focus the FCC's attention on the necessity to discern [adequate] reasons before allowing diversity . . . to disappear from the airwaves.

It is at this point that the story becomes extraordinary. The FCC of course complied with the D.C. circuit's order in the *WEFM* case and held the required hearing. But on the more general issue of its substantive responsibility to ensure program diversity, it simply refused to go along. Instead it issued a formal Notice of Inquiry, the purpose of which it described as follows:

> Over the years, the Commission has sought to avoid dubious intrusions into the broadcaster's programming judgments. . . . Now, however, the policy suggested by the Court of Appeals seems to require a much closer scrutiny of proposed changes in the programming decisions of broadcasters. We seriously question whether, under the Act's public interest standard, such close scrutiny is necessary or appropriate. . . . For this reason, we are instituting this inquiry to examine whether the Commission should play any role in dictating the selection of entertainment formats.

In short, the commission was asking the public to comment on whether the commission should do what the D.C. circuit had told it to do. And you can imagine how mad *that* made the D.C. circuit!

After considering public comments, the commission issued a Memorandum Opinion and Order which cited the statement, oft repeated in the D.C. circuit's own opinions, that "agencies and courts together constitute a 'partnership' in furtherance of the public interest," and then proceeded as follows:

> When such "partners" come to a point of fundamental disagreement, it is incumbent upon us to take a step back and rethink our entire position if this relationship is to be creative rather than destructive. . . . Our reflection, aided by extensive public comment on virtually every aspect of this matter, has fortified our conviction that our regulation of entertainment formats as an aspect of the public interest would produce an unnecessary and menacing entanglement in matters that Congress meant to leave to private discretion. . . . Any such regulatory scheme would be flatly inconsistent with our understanding of congressional policy as manifested in the Communications Act. . . .

The commission announced that its "new policy," which flatly contradicted that set forth by the court in *WEFM*, would be adopted in sixty days, barring application for judicial review. Well, you can imagine . . . !

Judicial review was of course sought, and the result was the D.C. circuit's opinion in the *WNCN* case, which held the commission's Policy Statement "to be unavailing [*unavailing!*] and of no force and effect." The opinion's tone of *lèse-majesté* is sufficiently conveyed by the following passage:

> The Commission repeatedly referred to *WEFM* as representing the "policy" of the Court of Appeals, and contrasted it unfavorably with the "policy" of the Commission. It called upon this court, as its so-called "partner" in the regulatory process, to step back and recognize that its "policy" is superior to our own.
>
> We should have thought that *WEFM* represents, not a *policy*, but rather the *law* of the land as enacted by Congress and interpreted by the Court of Appeals, and as it is to be administered by the Commission. This court has neither the expertise nor the constitutional authority to make "policy" as that word is commonly understood. . . . That role is reserved to the Congress, and, within the bounds of delegated authority, to the Commission. But in matters of interpreting the "law" the final say is constitutionally committed to the judiciary. . . . Although the distinction between law and policy is never clearcut, it is nonetheless a touchstone of the proper relation between court and agency that we ignore at our peril.

The FCC appealed to the Supreme Court and was completely vindicated. In its opinion rendered on March 24, the Court repeated what it had said less than three years earlier in the last major showdown between the D.C. circuit and the FCC, where the lower court was reversed for attempting to dictate FCC policy on the issue of cross-ownership between broad-

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cast media and newspapers: "A reviewing court . . . is not empowered to substitute its judgment for that of the agency."

Having dropped two bouts in a row, the last virtually a challenge match lost in most humiliating fashion, the D.C. circuit might have been expected to become more circumspect in converting its policy preferences into law. However, ...

Last April, less than a month after *WNCN* was handed down, the D.C. circuit decided *Gottfried* v. *FCC*. The petitioners in the suit were challenging the license renewals of eight Los Angeles television stations on the grounds that they had not made any special provisions (such as closed-caption programming) for the needs of the hard-of-hearing and the deaf. They cited section 504 of the Rehabilitation Act of 1973, which provides that "no otherwise qualified handicapped individual . . . shall, solely by reason of his handicap, be excluded from . . . participation in, be denied the benefits of, or be subjected to discrimination under any program or activity receiving Federal financial assistance." The FCC declined to hold a hearing on the renewal applications, on the ground that the petition did not raise any "substantial or material question of fact."

The D.C. circuit reversed the commission's action as to the one public television station involved, holding that section 504 applied to the station because it received federal funds and that the FCC's "public interest" mandate requires it to consider a licensee's compliance with statutory obligations of this sort. The court further found that section 504 did not apply to the seven commercial stations, rejecting the argument that the grant of a broadcast license constituted "Federal financial assistance"; and though it found that the "public interest" mandate of the Communications Act required the commission to take into account "the national policy of extending increased opportunities to the hearing impaired," it did not find that obligation alone to require a renewal hearing in the case at hand. All of those determinations are debatable, but they all clearly involve questions of law. The court went on, however, to assert that "some accommodations for the hard of hearing are required of commercial stations," and to warn that while it was willing to "defer today" to the judgment of the commission, "judicial action might become appropriate at a later date" if the commission did not "act realistically to require, in the public interest, that the benefits of television be made available to the hard of hearing now."

This last determination—characteristically taking the form of an obiter dictum and therefore not subject to appeal—assuredly does *not* address a question of law. In taking account of what the court appropriately found to be the "national policy" of assisting the hard-of-hearing (appropriately, though not necessarily correctly: Congress, after all, had sought to limit section 504 to federal grantees), the commission might well find that there are feasible actions the commercial stations should take. But it might also find the opposite, and the record before the D.C. circuit could not possibly support a categorical judgment that the latter finding would be an abuse of discretion. The court was, in other words, not only substituting its judgment for the agency's, but rushing to pronounce a judgment before the agency had even done so.

A few years ago, an unappealable decision-by-dictum such as this would have effectively determined communications policy. Even if the FCC courageously chose to ignore the court's mandate, its licensees (perhaps no less courageous, but having real money on the line) would surely comply, for fear of later being held in violation of their public interest obligations: Now, however, the innovative course charted by the commission in the *WNCN* case has shown the way to recapture policy-making authority: The FCC should simply convert the D.C. circuit's policy dicta from declaratory sentences to questions and set them down for rulemaking. If the court says "some accommodations for the hard of hearing are required of commercial stations," the commission should issue a Notice of Inquiry asking, "Should some accommodations for the hard of hearing be required of commercial stations?" And then it should proceed, as Congress intended, to make that policy judgment for itself—confident that the Supreme Court, at least, will sustain that judgment so long as it is "based on consideration of permissible factors and is otherwise reasonable." The process, of course, subjects the D.C. circuit court to a certain amount of indignity, but that is entirely of its own creation.

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Viewpoint

Jeremy Rabkin The Stroke of a Pen

THE REAGAN ADMINISTRATION has boldly proclaimed its determination to reassert traditional American values and to reverse the regulatory excesses and moral abuses of the last twenty years. High on the administration's list of such excesses and abuses one would expect to find the twisting of equal opportunity law in order to impose racial quotas and encourage racial preference. In a recent speech to the American Law Institute, Attorney General William French Smith did indeed take a firm stand against hiring quotas, calling them "perilously close . . . to fostering discrimination." The attorney general went on to criticize forced busing and to describe at length the administration's elaborate scheme to remedy the effects of past school discrimination by rewarding, with free college tuition, those parents who volunteer to have their children bused. Significantly, however, Smith did not announce any action with respect to hiring quotas. Nor has the White House given any hint of its intentions in this area.

Yet the fact is—a fact unknown to the general public and certainly not widely advertised by administration spokesmen—the President has right at hand the means for taking prompt and effective action in the quota field. It would not require congressional assent and, unlike innovative busing schemes, would not require prior judicial approval. President Reagan could, with a stroke of his pen, eliminate the nation's principal quota hiring program, the contract compliance program run by the Department of Labor. Since that program was established, not by legislation, but by unilateral presidential order, it can be readily altered or abolished in the same fashion.

The confusing signals from the White House—tough words, but no action—are certainly what the public has come to expect in this field. When Congress passed the Civil Rights Act of 1964, it gave profuse assurances that its prohibitions against "discrimination" would not mean the imposition of arbitrary "racial balance" requirements. It even included, along with its ban on race and sex discrimination in employment, an explicit provision emphasizing that nondiscrimination should not be interpreted as requiring any employer "to grant preferential treatment to any individual or to any group" on the basis of any statistical "imbalances" in its work force. Yet only a few years later, the Equal Employment Opportunity Commission (EEOC), in the course of enforcing this discrimination ban, was indeed requiring employers to adopt precise minority hiring and promotion quotas when they had been found guilty of unlawful discrimination. The courts upheld such remedies as necessary correctives for the employer's past discrimination, rather than "preferential treatment" for the sake of statistical racial balance. But since the beneficiaries of those remedies were usually not the same individuals who had been victimized by the employer's past discrimination (but simply members of the same race) and since the scale of the quotas usually bore no established relation to the number or proportion of minority job applicants previously turned away, the remedies looked very much indeed like the imposition of racial preference for the sake of statistical balance. Nevertheless, neither Congress nor the courts have done anything to prevent the extension of such practices by the EEOC (nor the equally questionable practice of using statistical imbalance as primary proof of discrimination in itself).

Racial Allocations in Employment

If the EEOC's enforcement policies risk the institutionalization of racial entitlements in American life, however, the Labor Department's contract compliance program already *is*

Jeremy Rabkin, former associate editor of Regulation, *teaches in the Department of Government at Cornell University.*

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in some sense the institutionalization of a racial allocation system in employment. The program is based on Executive Order 11246, issued by President Johnson in 1965, and applies to all businesses and institutions having contracts from the federal government—a category now embracing some 300,000 firms. While the Civil Rights Act simply prohibited discrimination on the basis of race, sex, or national origin, the executive order went beyond this to require all contractors—whether guilty of past discrimination or not—to undertake "affirmative action" to ensure "equal opportunity" in employment. At the outset, the Labor Department interpreted this to require only that contractors actively publicize their nondiscrimination policy. But by 1971 the department was requiring each contractor to develop an elaborate "affirmative action plan" to "increase materially the utilization of minorities and women" in its work force. The plan had to establish minority employment "goals" at each level of the contractor's work force (based on the statistical "availability" of minority workers in the relevant local "labor pool") and "timetables" for achieving these "goals" (based on the contractor's average hiring and promotion rates).

If the EEOC's enforcement policies risk the institutionalization of racial entitlements . . . the Labor Department's contract compliance program already is . . . the institutionalization of a racial allocation system. . . .

The Labor Department has always insisted that these "goals" are quite different from "rigid quotas" because contractors are only required to make "good faith efforts" to achieve them. But even the old-fashioned quotas used for restricting access to Jews and other minorities were not always "rigidly" observed. The evil in quotas, after all, is not that they reduce administrative flexibility, but that they make an individual's chances depend in some measure on the number of preassigned slots for those of his "group"—rather than strictly on his own personal qualifications, which is what respect for individual dignity and simple justice would dictate.

To be sure, the Labor Department has also piously denied from the outset that this scheme is intended to encourage "preferential treatment," since the "goals" are ostensibly calculated to reflect the "results" that an entirely nondiscriminatory employment pattern would achieve of itself. But no one can really know what the "results" of a truly nondiscriminatory employment policy would be for any particular employer: workers do not distribute themselves among firms in a perfectly random manner, and there is no reason to suppose that job qualifications (education, experience, talent, proven integrity, or ambition) are distributed in precise, statistically even proportions across every ethnic group at every level of employment. For all the Labor Department's protestations, at any rate, no one has ever lost a federal contract for practicing reverse discrimination. The conclusion is inescapable that the department's program is designed to ensure, not the nondiscriminatory treatment of individuals, but the employment "utilization" or "representation" of different groups in what Washington bureaucrats have decided are fair or appropriate proportions—and all this without even the EEOC's pretense that it is necessary to "remedy" proven instances of past discrimination, but simply as a worthy aim in itself.

Despite the brutal simplicity of its conception, implementation of the executive order program has been mired in endless complexity and frustration. Contractors complained from the beginning that relevant availability figures for local minority workers were unobtainable or unreliable, that hiring goals projected from these figures were bound to be unrealistic or unachievable, and that the entire process of formulating detailed goals and timetables for each different job category involved amounts of paperwork and administrative strain vastly disproportionate to the meager practical benefits that could actually be expected to result. The Labor Department scarcely helped matters either by continually revising and refining its requirements throughout the 1970s, or by its early decision to require minority employment goals, not only for blacks, but for the separate categories of Asian-Americans, "Spanish-surnamed Americans," and American Indians (identifications that have proved remarkably difficult to define or to attach to particular workers).

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And what has been achieved after a decade of enforcement? No doubt, some minority individuals do owe their jobs or promotions to the insinuating pressures of the executive order program—and no doubt many others, who would have advanced on their own merits, can thank the Labor Department for the suspicions of their fellow workers (and of prospective employers) that they are privileged beneficiaries of the company quota. Meanwhile, a variety of economic studies has revealed that the gap between average incomes for black and white workers is the smallest in those industries that are least likely to include federal contractors, that is, least subject to the complex requirements of the executive order program.

A Different Approach?

Thus, the Reagan administration has cause enough to reconsider the executive order program if only for the sake of honoring its promise to reduce excessive regulatory burdens on business. And business groups are already pressing it to do so. They were provoked into action because, in the last weeks of the Carter term, the Labor Department issued still another set of affirmative action regulations, which would make the program even more burdensome in some respects and would aggravate the redundancies and double burdens of the program's overlap with EEOC's antidiscrimination enforcement. Upon taking office, the new administration promptly postponed the effective date of these regulations and then, in mid-April, postponed the date for yet another two months. Business groups, however, have been urging the administration not to toy with the latest regulations but to ensure wider reforms by redrafting the executive order itself.

A redrafting of the order would, of course, be the easiest way to eliminate the hateful apparatus of goals and timetables. And it is worth noting that this could be done without absolving contractors from all affirmative action obligations. Contractors could still be required to publicize job offerings in minority communities or to establish training programs that would help minority employees (as well as others) advance to higher positions—without being forced into the degrading ritual of formulating precise minority employment goals. Interestingly enough, the Labor Department has never thought it necessary to demand that goals and timetables be established under statutes requiring government contractors to extend "affirmative action" to Vietnam veterans and to the physically handicapped (even though these are the only areas where Congress has directly mandated affirmative action). Yet no one has charged that the department's implementing regulations for those programs—involving "outreach" recruitment and some readiness to accommodate the special needs of these groups—are worthless because they avoid quotas.

But it is not at all certain that the Reagan administration is prepared to break so sharply from the quota pattern of the past decade. True, candidate Reagan directly condemned quotas in the fall campaign, as did the Republican Party platform. But so at various times have the NAACP and other civil rights groups (along with Presidents Nixon, Ford, and Carter) —while insisting that the Labor Department's goals and timetables had no taint of the acknowledged evil in quotas. More to the point, perhaps, the U.S. Chamber of Commerce, which has been in the forefront of demands for an overhaul of the executive order program, has recently affirmed its support for "measurable methods to increase [minority] participation in the work force through the voluntary use of goals, timetables and good faith efforts." Indeed the business community as a whole has little reason to press for an end to race-conscious hiring policies: filling a preset number of job slots with candidates of the "right" race or sex is an easy way to avoid "discrimination" charges from EEOC, and most large corporations already have institutionalized "equal opportunity" units within their personnel offices (units with a stake in the continuation of the process).

Thus the White House may decide to play it safe. It could choose to reform the executive order program in such a way as to reduce paperwork costs and administrative vexations for contractors (by, for example, allowing each goal to cover a large number of separate job categories) without at all really addressing the moral problem of government-mandated quotas. Regulatory reformers in the adminis-

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tration might conclude—as many business leaders seem to have already concluded—that renewed controversy over the quota issue would jeopardize the chances for such badly needed operational reforms in the program. Even those in the new administration with stronger feelings of principle may decide that there is no point in President Reagan's sticking his neck out on this one program, when Congress will still have to act to eliminate the quota aspects of EEOC enforcement and of other statutory programs. And they may even console themselves with the hope that such congressional action may not be too far off: in every one of the last four years the House of Representatives has approved legislative riders that would have prohibited the Department of Labor from enforcing any rule or order "which includes any ratio, quota, or other numerical requirement related to race, creed, color, national origin, or sex." Such measures have always been derailed in the Senate up until now. Now, of course, the Senate is a very different body, one that presumably will be more likely to favor the idea.

Yet, however tempting it might be to leave the issue for Congress to work out, that would be a great mistake. There is no certainty, to begin with, that Congress will act decisively if left to itself. Thus, for example, while the House passed an anti-quota amendment this spring, it was promptly derailed by the Senate in conference committee on June 2, ostensibly on the grounds that the Senate does not like legislative riders on appropriations bills. Even if the full Senate proves amenable to the idea in some other form, many House members who voted for the quota ban in past years might shy away; for they are no longer able to predict with confidence that the Senate will "save" their votes from having any effect.

President Kennedy nurtured the climate of opinion that ultimately led to the 1964 Civil Rights Act. . . . President Reagan may have to take unilateral action in the same way to help crystallize a political consensus for a deeper reaffirmation of the principle of nondiscrimination today.

They are much more apt to be pressed into action if the President exerts the strong leadership he displayed in the recent budget battles. President Kennedy nurtured the climate of opinion that ultimately led to the 1964 Civil Rights Act by issuing a strong executive order banning race discrimination by government contractors. President Reagan may have to take unilateral action in the same way to help crystallize a political consensus for a deeper reaffirmation of the principle of nondiscrimination today.

The Need for Leadership

And that, in the end, is the strongest argument for decisive presidential action. For it should be plain by now that new legislative restrictions, no matter how broadly cast or emphatically worded, cannot by themselves lay the quota issue to rest. Bureaucrats and judges have been only too ready to pervert clear congressional directives in this area in the past. They are unlikely to be drawn up short this time by anything less than major legislation representing an overpowering national consensus. For such legislation, clear presidential leadership is indispensable. It may well be that the forging of a new legislative consensus requires some compromise; and whether it does or not, some compromise will certainly be proposed. The President cannot play his crucial leadership role in that legislative process if he has not first acted to set his own house in order —that is, eliminated the scandalous quota scheme in his own executive domain.

Right now, to be sure, there is no clamor for President Reagan to take decisive action in this area, nor even much recognition of how much he can do on his own authority. That is all the more reason for him to act, and to act speedily. For while every opinion poll confirms that overwhelming majorities of both whites and blacks are opposed to quotas and racial preference schemes, the current passivity on this issue suggests that the public may now put these evils in the same category with tax loopholes and special interest subsidies—too entrenched to be seriously challenged. It is just the sort of cynicism and resignation President Reagan has urged us to overcome elsewhere. Let him continue here. ■

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HARNESSING REGULATION

The Evolving Role of White House Oversight

George Eads

PRESIDENT REAGAN'S creation of a cabinet-level regulatory appeals group and his issuance of Executive Order 12291 represent the most thoroughgoing attempt thus far to bring the regulatory activities of executive branch agencies firmly under White House control. Not that the President or his aides will dictate each and every decision of those agencies. But the clear intent is that their regulatory programs bear a much heavier presidential imprint than ever before.

In a real sense, the executive order of February 17 marks the final emergence of regulation as a governmental function deserving the same level of attention as the raising and spending of money. We do not yet have a formal regulatory budget, but enough basic budget-like controls are now in place, at least on paper, to permit the President to shape regulatory programs, singly and overall. Whether the White House will use these controls to view regulation in the context of other federal activities and coordinate the whole—for this is surely what regulatory budgeting means—or whether it ends up acting merely as sharpshooter, taking aim at this or that politically sensitive regulation, depends critically on the Office of Management and Budget (OMB) and, more particularly, its new Office of Information and Regulatory Affairs (OIRA). Unfortunately, even at this early stage there are signs that OIRA will choose, or be forced by events to settle for, the sharpshooter's role.

To some, the new regulatory oversight mechanism should be judged by one measure: If it causes the regulation-issuing process to shut down, it has succeeded. If it does not, it has failed. This view is naive on at least two counts. First, it ignores the fact that, in becoming as important an instrument of government as taxing or spending, regulation has become just as indispensable. Clearly it is here to stay. Second, the view is naive because it also ignores the need to deal with the vast body of existing regulations. Doing this sensibly requires a well-functioning oversight process that can identify the rules needing review, develop information to support its case, and ensure that the agencies adopt the needed reform.

Thus, assessing the performance of the Office of Information and Regulatory Affairs will not be simple. Certainly OIRA will slow the pace of new regulations—probably a good idea. But how will it decide which regulations should be issued? How can it ensure that new regulations intrude on private decisions only to the degree necessary? And perhaps most important, can it establish a rational process for reviewing and reforming existing regulations?

The New Framework

In theory, Executive Order 12291 provides all the tools needed to accomplish these tasks. The order certainly is impressive both in its scope

George Eads, a member of President Carter's Council of Economic Advisers and chairman of the Regulatory Analysis Review Group (1979–81), is now a senior economist in the Washington office of the Rand Corporation. The views here are his own.

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and in the extent to which it rearranges the power relationships that prevailed under previous administrations.

Substantive Requirements. Certain sections of the order resemble or only modestly extend executive orders issued by Presidents Gerald Ford and Jimmy Carter. The prime example is the requirement that agencies subject proposed "major" rules to formal economic analysis and make these analyses (now to be called "regulatory impact analyses") available for public comment at the time rules are formally proposed.

In many important respects, however, the order moves far beyond the Carter and Ford systems. The Carter administration always took pains to stress that its requirements should not be interpreted as subjecting rules to a "cost-benefit test." Instead, agencies were to identify costs and benefits, to quantify them insofar as possible, and either to choose cost-effective solutions *or* to explain why they had not. Moreover, the burden of proving that proposed rules were *not* cost-effective lay not with the agencies but with senior White House aides. In addition, it was made clear that the administration was not trying to impose new substantive standards on those responsible for issuing rules.

Reagan's program goes much further. Except where expressly prohibited by law, the new executive order *requires* that a cost-benefit test be applied and met. An agency may not even propose regulatory action unless it can demonstrate that the potential benefits to society outweigh the potential costs. (How it is to make this demonstration, especially when many regulatory benefits and costs are nonquantifiable, is not explained.) If the agency proceeds to regulate, it must choose (1) the objectives that maximize net benefits to society and (2) the specific regulatory approaches that minimize net costs to society. Finally, each agency is to set its regulatory priorities so as to maximize aggregate net social benefits, taking into account three factors—the condition of the national economy, the condition of the industries affected by its regulations, and the impact on those industries of regulatory actions contemplated by other agencies. This last requirement is a puzzler. When asked recently how agencies could meet it, OIRA Administrator Miller replied: "Relatively easily . . . by consulting the regulatory calendars that each agency is required to publish twice a year" (see "Deregulation HQ," interview with Murray L. Weidenbaum and James C. Miller III, *Regulation*, March/April 1981). But that does not explain how, in practice, an agency is to calculate the cumulative impact of such regulations and how it is to coordinate its actions with those of other agencies.

Oversight Procedures. The oversight mechanism is also being drastically changed. Under Carter, the various oversight functions were deliberately parceled out among many offices. OMB monitored compliance with the regulatory analysis requirement and, beginning in late 1979, became increasingly important in monitoring regulatory paperwork as well. The Council on Wage and Price Stability (CWPS) and, in the case of particularly important regulations, the interagency Regulatory Analysis Review Group (RARG) maintained quality control of agency analysis by filings for the public record. The Regulatory Council compiled calendars of future proposed regulations, spotted and resolved regulatory conflicts, and encouraged the adoption of innovative regulatory techniques. Finally, several of the President's closest advisers followed important regulations from the close of the public comment period until the issuance of the final rule.

The Reagan executive order consolidates most White House oversight functions in OMB's Office of Information and Regulatory Affairs. In effect, OIRA has become the gate through which all important regulations must pass—not just once, but twice—on their way to becoming law. The order gives OIRA extremely broad powers. It can overrule agency determinations on whether a proposed rule is to be considered "major." In the case of a major rule, it must receive the draft regulatory impact analysis at least sixty days before the agency publishes the Notice of Proposed Rulemaking. If it finds the analysis weak or believes that important alternatives have been neglected, it can delay publication of the Notice of Proposed Rulemaking until the agency has adequately responded to its concerns. There is no requirement that a record be kept of these initiatives or of the agency's response. The agency may appeal only to the President's Task

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Force on Regulatory Relief or to the President himself.

It is important to note that all this is to take place *before* a regulation has been formally proposed. In that respect, the new process is like the behind-the-scenes preparation for the President's financial budget.

The Carter and Reagan systems also differ in the use made of the formal public comment period. Under Carter, it was during this period that RARG (for ten or so key regulations a year) or CWPS prepared and filed comments on agency proposals. In the case of RARG filings, a draft was written by analysts at the Council of Economic Advisers (CEA) and CWPS and circulated to all RARG members—including the agency whose proposal was under review—who then met formally to discuss the issues involved. Comments and dissents were incorporated into the draft, and the final report was placed on the public record at the close of the comment period. The Reagan plan dispenses with public filings by executive office agencies such as CWPS and interagency groups such as RARG. Any views that OIRA or any other agency may have on a proposed rule presumably will already be reflected in the proposal when it is published. Moreover, as noted earlier, the executive order does not provide the public with an opportunity to learn what these views were and how they differed from the views of the agency proposing the regulation.

After formal public comment, while the agency was drafting its final rule, the Carter procedures provided for monitoring by top presidential advisers—the CEA chairman, the OMB director, the President's assistant for domestic policy, as well as his inflation adviser and science adviser. They (or their aides) met regularly to track important rulemakings, assign responsibility for White House–agency liaison, and decide whether to involve the President. (The President was kept informed but, for a variety of reasons, rarely asked to mediate disputes with the agencies.) Under the Reagan system, OIRA fulfills this monitoring function, getting one more shot at the agency's proposal. Thirty days before the rule is to be issued, the agency must transmit the final regulatory impact analysis to OIRA. If OIRA objects, it can hold up the rule until its objections are resolved or until it is overruled by the President's task force or the President himself. Only in the event of disagreement on the final rule is the substance of these discussions to go into the rulemaking file, where it will be available to courts that may review the matter.

Another important difference between the two systems should be noted. During the so-called post-comment period, the Carter White House carefully limited its contacts with the agency so as to minimize the possibility of ex parte contacts that might "taint" the rulemaking. Thus the task of keeping in touch with the agency was informally assigned to a single person—usually the one who had been following the rulemaking most closely. And the White House offices having the most frequent contact with industry were excluded from agency–White House deliberations to avoid their becoming a conduit for information not on the public record. The Reagan administration's decision to broaden the circle of individuals potentially involved during this period to include a number of cabinet officers (as members of the President's Task Force on Regulatory Relief) will make the policing of outside contacts substantially more difficult. It will be impractical to ensure that these individuals, who have only sporadic involvement in rulemaking and who, in the course of their normal duties, have numerous contacts with industry, will confine themselves to the rulemaking record in reaching decisions.

Additional Responsibilities. The process described above applies to new rules. But the vast body of regulation already in place also needs attention. The Carter system required that agencies periodically review existing rules and eliminate or revise those that were outmoded. But it never created a formal "sunset" procedure to give this requirement force. Reagan's executive order does. It allows OIRA to designate existing rules for analysis and to establish schedules for such review. Revising a rule requires, of course, that a new rule be proposed, at which point the procedural and analytical standards of Reagan's executive order apply.

OIRA has still more powers. President Reagan has abolished the Regulatory Council, transferring to OIRA the job of publishing the Regulatory Calendar and of identifying and eliminating duplicative, overlapping, and conflicting rules. OIRA will also implement the Federal Regulatory Flexibility Act of 1980, which

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addresses the regulatory problems of small business, and the Paperwork Reduction Act of 1980, which seeks to limit the paperwork that agencies impose along with their regulations. Finally, OIRA is specifically charged with developing procedures for estimating the annual benefits and costs of agency regulations, on both an aggregate and an industrial sector basis—"for purposes of compiling a regulatory budget."

Can OIRA Handle the Task?

If it wants to conduct effective regulatory oversight, OIRA must show everybody involved—the agencies, the Congress, the courts, the regulatees, and the public—that it can use its powers responsibly. Its assertion of authority must be matched by competence in exercising that authority. Considering the enormous scope of its powers and its apparent intent to move aggressively, OIRA would find itself in trouble on these grounds even if its resources were ample. But they are not. Furthermore, to a large extent they are ill-suited to the task of regulatory analysis.

Staff Resources. According to the Miller/Weidenbaum interview in *Regulation*, OIRA will have about ninety slots and will, in addition, be aided by OMB's regular staff. But the numbers give a misleading picture. Few if any of the ninety slots are new, because OIRA is a combination of three existing units: the Office of Regulatory and Information Policy (RIP) within OMB, the Office of Government Programs and Regulations from the now-abolished Council on Wage and Price Stability, and the Office of Statistical Policy (OSP) from the Department of Commerce. Moreover, of these, only the twenty-person CWPS staff is experienced in the techniques of regulatory analysis. The forty-five RIP analysts are primarily trained to monitor paperwork burdens and oversee the agencies' technical compliance with the executive order. The Statistical Policy Office's twenty-five analysts may be helpful to OIRA in standardizing techniques for cost-and-benefit accounting, but they are not regulatory specialists and are not likely to become so. As for drawing support from elsewhere in OMB, while some of OMB's 250 budget examiners may be available from time to time, their training and professional inclination equips them to monitor direct federal expenditures, not the indirect costs of regulation.

In short, because the influence of regulation pervades the entire economy, OIRA's duties are considerably broader than those of the conventional financial budgeters, while its resources are far smaller. But its analytical horsepower is significantly less than that of the offices whose functions it has assumed.

Considering the stress the Reagan program lays on formal cost-benefit analysis of regulations, . . . the meagerness of OIRA's analytical resources cannot help but undermine its credibility.

Analytical Capabilities. Considering the stress the Reagan program lays on formal cost-benefit analysis of regulations, taken both individually and in groups, the meagerness of OIRA's analytical resources cannot help but undermine its credibility. Even more serious is the likelihood that OIRA will miss opportunities for reform. Important issues may fall between the cracks because no one knows enough about their significance to challenge them, or because none of the parties involved has the incentive to raise them or the capability of analyzing them properly.

For example, during a 1980 proceeding of the Environmental Protection Agency (EPA), an opportunity arose to broaden the definition of "source" for purposes of new source reviews in areas of the country not meeting national ambient air quality standards. The importance of broadening the definition was brought to the attention of White House staff very late in the rulemaking process—and not, incidentally, by industry. The contemplated change would have been helpful to industry, especially steel, because it would have allowed a plant to make replacement investments free of EPA's new source reviews so long as its emissions were not significantly increased. The change also would have reduced total emissions. But EPA's more restrictive definition was a valuable weapon for forcing steel firms onto compliance schedules, because it permitted the agency to

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hold any modernization investment "hostage." Thus EPA was opposed.

The White House analysts worked up estimates showing the favorable impact of the change on steel industry investment. However, after heated discussions between senior White House officials and EPA's leadership, EPA prevailed. (Subsequently, with the advent of the Reagan administration, EPA announced that it would repropose the regulation to permit the issue to be reexamined.)

In this instance, having a highly competent analytical staff strategically located within the White House with sufficient resources to prepare a well-documented analysis helped ensure that an important issue that otherwise might have slipped by at least got considered. It might be argued that, under Reagan, no agency will ever try to slip a regulatory change past the White House. My experience in several administrations suggests otherwise.

Agency parochialism is not the only thing that a strong White House analytical capability can help prevent. Sometimes there are important issues lurking in a rulemaking that only the White House has the incentive to raise. An example occurred during EPA's rulemaking on premanufacturing notification procedures for new chemicals and new chemical uses (which is still pending). White House analysts became concerned that the proposed procedures would adversely affect innovation in the chemicals industry and suggested a RARG review. EPA voted no, contending that this was not the proceeding in which to address the innovation issue and that the information needed to make a finding was not available. The chemical industry, for its part, seemed indifferent, possibly because the procedures in question would have an ambiguous effect on industry profits. By slowing the rate of innovation of new chemicals and increasing the cost of developing new uses for chemicals, the procedures could substantially enhance profits on the sale of *existing* products and differentially affect innovation in large and small firms.

Nevertheless, RARG launched a review, and the resulting report, filed by CWPS in March 1981, shed important light on an issue of national importance. It might be argued that in the Reagan administration the agencies themselves will see to it that all significant issues are raised and properly analyzed, or that OIRA, though thinly staffed and overworked, will be able to single out the issues of importance that the agencies let drop. I have my doubts. Or it might be argued that the agencies will forget about such "trivialities" as premanufacturing notification once the Reagan oversight process really gets rolling. Again I am doubtful. Congress may be in an antiregulatory mood right now, but it will be interesting to see how long the mood lasts if a new chemical harms someone and if the harm might have been prevented by tight regulation.

The matter of adequate resources is thus critical in determining how successful OIRA will be in shaping the regulatory process. Effective and credible oversight requires a staff that is familiar with both agency programs and the affected industries, and that also has the ability to set priorities and ask cross-cutting questions (including whether proposed "reforms" of one agency may increase costs elsewhere). Merely requesting industries, trade associations, and other interests to submit "hit lists" of regulations they would like to see eliminated (as Vice President Bush did on March 25) may be good politics. But it is no substitute for developing independent judgments as to which regulations make sense and which do not. Either OIRA's analytical resources will have to be greatly increased, or its objectives greatly trimmed—and maybe both.

Can the Agencies Do Their Part?

Of course, OMB will have help with regulatory oversight, just as it does with financial budget oversight. Indeed, the overwhelming bulk of the responsibility for preparing cost-benefit analyses must necessarily fall on the agencies themselves. A central White House staff can never know enough about the detailed workings of regulatory programs to prepare a large number of regulatory analyses from scratch; it generally will have to rely on raw material generated by the agency, and the quality of this material is crucial. A major paradox of the Reagan program is that while giving OIRA an extremely broad mandate and high political visibility, it lays a much greater analytical burden on the agencies than did the Carter procedures. Unfortunately, however, it is likely to weaken the agencies' incentive to perform

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this role in a way consistent with both presidential objectives and legal requirements.

How are the agencies to be motivated? The quick answer is that President Reagan is appointing agency heads who share his basic regulatory philosophy. But that answer is certainly too quick. A general desire to check regulation does not easily translate into an effective program of regulatory management.

Improving Analytical Capabilities. Initially, the regulators typically responded to both President Ford's and President Carter's executive orders by preparing analyses designed solely to support regulatory options they had already chosen and to "prove" that their proposals actually generated few if any costs. Only gradually did they start to use these analyses for the intended purpose: to help decision makers identify the likely impacts of a *range* of possible regulatory actions. In general, it was not until an agency had been through a number of RARG or CWPS reviews that it began to appreciate the breadth of information that could be generated during a rulemaking. Indeed, one of the most important (and perhaps least appreciated) objectives of the RARG and CWPS efforts was to improve agency analytical skills. Through the collegial RARG process, the distinction between "good" and "bad" analysis was slowly being transmitted throughout the bureaucracy.

Even so, by the end of the Carter administration, very few agencies were good at regulatory analysis and some did not yet understand what it meant. There is little reason to think this situation has improved since then, and some reason to think it has worsened: because of budget cuts and hiring freeze, a number of the best analysts have returned to the private sector.

The prospects would be bleak enough if the agencies had only to analyze the impact of individual proposed or existing regulations. But each of them must also develop priorities for its entire regulatory program and understand how its proposed rules and those of other agencies accumulate to influence an industry or sector. I am not aware of any agency qualified to do this competently at the present time.

Paradoxically, the obligatory cost-benefit test may well be a hindrance to obtaining good analysis. Considering the state of the art in estimating both benefits and costs, the requirement amounts to an invitation to fraud. It would be much more sensible merely to require that agencies identify (and quantify, to the extent possible) whatever costs and benefits they consider likely to flow from the proposed regulations. This, coupled with the lifting of all statutory bars to considering and balancing costs and benefits (such as the bars contained in the Delaney Amendment and the Clean Air Act), would be a powerful spur to sensible regulation. Unfortunately, not even the regulatory reformers in the Republican-controlled Senate seem willing to face this issue squarely. Instead, their major proposal would merely codify the procedural requirements of the executive order, tightening the procedural straightjacket that the courts have been increasingly imposing upon "informal" rulemaking.

Paradoxically, the obligatory cost-benefit test may well be a hindrance to obtaining good analysis. Considering the state of the art . . . the requirement amounts to an invitation to fraud.

But there is also a practical problem. Suddenly imposing a strict cost-benefit test on this gradual learning process means that sensible new regulations, or revisions in existing regulations, may be stalled for lack of acceptable supporting analysis.

Improving Incentives. A great deal depends on how OMB chooses to interpret the requirements of the new executive order. If OIRA acts as an understanding teacher, showing tolerance for agencies as they struggle to learn and providing them with the resources needed to upgrade their analytical skills, then improvement can continue. If OIRA operates as a stern judge, however, virtually all regulations that come to its attention will fail its test—and not necessarily because they are not cost-beneficial.

Finally, progress could stop entirely if a harassed and overextended OIRA yields to the worst temptation: to give each analysis only cursory review and then either permit rulemakings to proceed if the analysis reflects politically desired results or bounce it back if it

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does not. The power of this temptation is suggested in the *Regulation* interview. When pressed on whether OIRA would apply the full procedural treatment to a rule purporting to *reduce* regulatory burdens by several hundred million dollars, Miller replied: "If OMB . . . were convinced on the basis of evidence, *however sparse,* that such a reduction would occur, a waiver would be granted immediately" (italics added). But he would give the full "treatment" to a rule that would raise costs, possibly even by only a small amount—if OMB chose to call the rule "major." This may seem an appealing short-run strategy for getting regulatory proposals changed without a lot of bother. But it runs serious risks of court intervention and, more to the point here, it undermines agency incentives to do serious analysis. Indeed, it returns regulatory analysis to the primitive stage of justifying predetermined outcomes.

Intervening Too Early?

Only occasionally, and usually only at an agency's request, did officials in the Carter White House concern themselves with actually shaping a regulatory proposal before it was opened to public comment. This approach had its drawbacks. As more than one expert has noted, agencies often tend to structure regulatory proposals in ways that severely limit their scope for final rulemaking. Yet RARG and CWPS, by carefully monitoring developing proposals, were able to ensure that rulemaking discretion was not unduly narrowed. And by zeroing in on agenda-setting actions—first-of-a-kind rulemakings, policy statements, and so on—the White House could further increase the range of options left open.

While the Reagan scheme's concentration on the pre-proposal stage permits—at least in theory—consideration of the broadest possible range of options, it is questionable how much this will help in practice. A major problem is that agencies use the Notice of Proposed Rulemaking in different ways. Sometimes agencies use it to identify options having a reasonable chance of adoption—in which case considerable effort has been expended before the formal notice is issued and a regulatory impact analysis would make sense. Other times, however, agencies use the NPRM as a tool for gathering data on the industries they intend to regulate and on the possible consequences of various regulatory options. After analyzing the data produced, they repropose the regulation. In this case, there is little point in doing a regulatory analysis before the second NPRM is issued. All that the agency and OIRA would have to work with would be sweeping claims of what the regulation *might* do if the agency went as far as it conceivably could under its authority. And the numbers submitted by interested parties would represent "worst case" scenarios—useful for attracting headlines but not for understanding what the effect of the actual regulation would be.

(It should be noted that some agencies employ a device called the Advanced Notice of Proposed Rulemaking, or ANPRM, to gather the information required to frame intelligent regulatory options. This should be encouraged. And if OIRA's formal powers do not now extend to ANPRMs, the temptation to extend them should be resisted. OIRA will have more than enough to do if it concentrates only on genuine NPRMs and ignores the fishing expeditions.)

Less Chance for Public Participation

During the Carter administration, some outside groups complained that they were unable to comment formally on CWPS's and RARG's contributions since those contributions were not filed until the end of the comment period. This view is echoed by Murray Weidenbaum in the *Regulation* interview. He dismisses RARG's influence by noting that its comments were filed "literally minutes before the comment period closed—which restricted somewhat their capacity for stimulating public dialogue." In practice, however, the filing schedule did not prove to be a serious problem. We found that, with months or often years elapsing between the close of public comment and the time a rule is made final, there was ample time for public discussion of and even formal public comment on a RARG intervention. In one case, an agency reopened a comment period expressly to receive comments on RARG's analysis. In another case, a "public interest" group prepared a detailed analysis of a RARG filing and CWPS prepared a rebuttal; both documents were placed

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in the record, even though the comment period had closed. In short, under Carter, there was liberal opportunity for public comment on White House interventions up until the very last stage of rulemaking, and comments were liberally offered. And the filings performed a useful educational role for the public and the Congress.

Contrast this with the information blackout under the Reagan process. A record of the critical pre-proposal discussions between the agency and OIRA is not required, and no document reflecting the administration's views need be placed on public file. A record of agency-OIRA discussions after the comment period will be put into the file, if at all, only when the rule becomes final. And nothing ensures that this record will be in any way complete. No wonder that a Washington attorney (William Warfield Ross) has advised his fellow attorneys that "there may be highly significant conversations going on between agency heads and the White House" before or during rulemaking proceedings about which they know nothing. His conclusion: "Now more than ever, . . . the race will be to the swift, to the enterprising and to those with access to the levers of power, not only in the Congress and the regulatory agencies, but also in the presidential office" (*National Law Journal*, April 27, 1981).

Whither Regulatory Oversight?

The Reagan initiatives can best be viewed as a logical and significant extension of experimentation begun by President Nixon and carried forward by his successors, the exact form reflecting each President's character, view of regulation, and attitudes toward bureaucracy. Each successive experiment has borrowed from the previous ones and would not have been possible but for the earlier efforts. Reagan's version of regulatory oversight borrows much of its procedure from Nixon's "quality of life review" and many of its analytical requirements from Ford's inflation impact statements. It draws on the capacity for analysis nurtured by Carter and will rely heavily on what is perhaps his administration's most important innovation in this area—the Regulatory Calendar. However, it discards the concept of public filings in favor of behind-the-scenes discussions between agencies and OMB—a loss whose importance has yet to be understood. And while the Regulatory Council and RARG brought about greater interagency cooperation, not by commanding it, but by showing agencies that reform could be in *their* interest, OIRA seems inclined to abandon this approach—another important loss.

So, an experiment it certainly is. It is bound to be tested in the courts and, over the course of the Reagan administration, is likely to undergo major changes. For this reason it would be especially unfortunate if either its current structure or its current procedures were embodied into law. Let it first prove itself by operating under the more flexible arrangement of the executive order. Most important, Congress should avoid writing into law the developing "common law" of hybrid rulemaking in the mistaken notion that slowing the regulatory process to a crawl is somehow the same thing as deregulation. If Congress feels compelled to act, let it take on a task that the Carter administration certainly would have tackled had it won a second term—designing major changes in the substantive standards agencies apply in rulemaking. This does *not* mean legislating a mandatory cost-benefit test for all regulations. Congress should merely remove the statutory language that prevents agencies from considering costs and from undertaking both intra- and interagency balancing of objectives. This, combined with permitting tolerably flexible administrative procedures, would be sufficient to produce all the regulatory reform that one would reasonably want.

Congress should avoid writing into law the developing "common law" of hybrid rulemaking in the mistaken notion that slowing the regulatory process to a crawl is somehow the same thing as deregulation.

For regulation to be a useful tool in promoting society's goals, it needs to be harnessed. But the oversight process must be professionally run and adequately staffed. It must not mimic the Queen of Hearts in *Alice in Wonderland*, constantly running hither and yon shouting, "Off with his head." ■

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REGULATING NETWORK TELEVISION

Dubious Premises and Doubtful Solutions

Stanley M. Besen and Thomas G. Krattenmaker

WHETHER MEASURED by viewing levels, revenues, or profits, network broadcasting dominates television, far outstripping the activities of the "independents" and public TV. In the 1979–80 broadcast season, ABC, CBS, and NBC captured almost 90 percent of the prime-time viewing audience. And in calendar year 1979 they, along with network-owned stations and affiliates, accounted for more than 90 percent of both the revenues and profits of the TV broadcasting industry.

Network domination of broadcasting has not, of course, gone unnoticed by the Federal Communications Commission (FCC). Indeed, the commission has launched major studies of the "problem" roughly every twenty years. The first occurred in the late 1930s, when the issue was network dominance of radio, and the second in the mid-1950s when the concern had shifted to TV. As an outgrowth of these studies, the commission adopted rules restricting the contractual relationships between the networks and their affiliated stations and between the networks and their program suppliers.

The FCC's third major study of network dominance, announced in 1977, started down an identical track. The mandate contained in the commission's *Notice of Inquiry into Commercial Television Network Practices* was predicated on the same assumption that had provided the basis for previous rulemakings: network dominance is a problem and the way to solve it is to regulate the networks' commercial practices. Thus the original plan of study was to examine the existing rules on network practices and suggest ways for making those rules more effective.

Stanley M. Besen, senior economist at the Rand Corporation, and Thomas G. Krattenmaker, professor of law at the Georgetown University Law Center, were co-directors of the Network Inquiry Special Staff at the Federal Communications Commission, 1978–80. The views here are their own.

What Is Network Dominance?

In 1978 the FCC's new chairman, Charles Ferris, asked us to become co-directors of the study. Our first problem was the approach taken by the commission in the Notice of Inquiry. To us, it seemed odd for a number of reasons:

- It ignored a major finding of the previous network inquiry, which had concluded that the basic sources of network dominance "appear to be the shortage of TV stations and the market environment and commercial incentives supporting network-station affiliation . . ." and that dominance will persist in the absence of "major technological change in the nature of the television industry or in the form of telecasting . . ." (*Network Broadcasting*, 1958). That this view was correct was clearer than ever by 1977. Yet the Notice made not a single reference to the subject.
- It disregarded a considerable body of academic literature indicating that past commission policies had actually increased, rather than decreased, network dominance. It was widely argued, for example, that by limiting the entry of networks that make use of new

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technologies, such as cable TV, and by placing constraints on the provision of programming financed by direct viewer payments, the commission had sheltered the existing networks from competition.

- The Notice read as if the television industry still consisted only of advertiser-supported over-the-air broadcasting, despite the enormous expansion since the 1950s in the variety of technological alternatives for providing television services. These alternatives include an expanded cable industry, a nascent multipoint distribution system business, embryonic videodisc and videocassette industries, and a visionary direct satellite-to-home broadcasting service.
- There was not the slightest intimation that experience with the last twenty years of regulation had created any doubts about the course the commission had pursued. This omission is especially strange in that the Notice suggested that network dominance might actually be increasing despite the panoply of rules adopted to prevent it.

One should resist the temptation to conclude that these oddities stemmed merely from the commission's failure to read its own staff's report. For the fact is that they are fully in accord with the commission's notion of network dominance. Historically, the FCC has been concerned solely with preventing network practices that restrict competition *within* the existing system. Thus, in its Notice of Inquiry, it took as an indication that network dominance may have increased the fact that network programs were occupying a growing proportion of time on affiliated stations, and it invited comments on whether the increase "would significantly impede the development of additional networks, and other syndicated program offerings in competition with network programming."

Although the commission had long conceded that the networks provide a valuable service by offering a broad array of programs, it feared they might unduly limit non-network sources from selling programs to affiliates. Thus, it had extensively regulated network-affiliate contractual policies. When that failed to prevent the networks from offering and their affiliates from accepting programming that occupied almost all of the most valuable station time, the commission resorted to the prime time access rule (1970). This rule, which forbids affiliates in the top fifty markets from carrying more than three-and-a-half hours of network entertainment programs during the four hours of prime time, is the source of the low-budget game shows that monopolize early evening TV.

It is important to note that the purpose of these rules, and a parallel set of rules placing limits on dealings between networks and program suppliers, was to increase the number of different sources supplying programs to stations, but not the number of competing outlets available to viewers. Indeed, the commission apparently saw no inconsistency in trying to address network dominance by reducing the power of existing networks while at the same time erecting barriers to the creation of new networks.

Clearly, our first task was to redirect the study to correct this shortsighted view of network dominance. A *Further Notice of Inquiry* was issued that emphasized the relevance of examining the barriers to entry confronting new networks and that questioned whether it was realistic to focus exclusively on industry practices within the three-network broadcast system.

The final report of the network inquiry special staff, submitted in October 1980, contained four conclusions quite incompatible with the FCC's traditional approach:

- The commission has failed to understand the function of networking—which is to distribute programs to a large number of geographically dispersed viewers. Networking is not an aberration or a necessary evil, as the commission seems to have thought, but an inevitability—since the costs of producing and distributing a program are largely unaffected by the number of viewers who watch it. Moreover, because there are economies that extend across programs, networks are likely to be formed to offer an extensive array of programs rather than just one. Finally, drawing the line between expansions in network activities that are justified by these economies and expansions designed to deter potential competitors will be exceedingly difficult.
- In adopting policies designed to shift income from networks to affiliates or program suppliers, the commission has frequently confused disputes over the distribution of industry profits with matters affecting the public inter-

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est. Furthermore, few if any of these policies are likely to succeed in shifting earnings or, more important, in benefiting viewers.

- The commission has failed to appreciate how difficult it is to regulate an industry by prohibiting a number of discrete contractual practices. Its general approach has been to adopt rules without a detailed analysis of their likely effects on the behavior or incentives of industry participants; and, until our study, it had never examined a single rule in operation. Apparently the FCC thought that simply adopting a rule was sufficient to accomplish that rule's purpose.

... the commission has failed to understand how closely the problem of network dominance is linked to its own policies.

- Most important, the commission has failed to understand how closely the problem of network dominance is linked to its own policies. During the period when it was trying to control network dominance through detailed regulation of contractual practices, it also pursued policies that protected the existing networks and their affiliates against competition from alternative sources of national program distribution. Happily, some of those barriers have been relaxed in the last half dozen years, and we can now anticipate a television system that, although dominated by networks, is dominated by such a large number of them that no one will really care.

The Economics of Networking

The FCC's ambivalence about networking dates back to its early studies of radio broadcasting. In its *Report on Chain Broadcasting* (1941), for example, it conceded that chain broadcasting—that is, networking—gave advertisers a strong incentive to finance expensive programs, thereby benefiting both the listening public and broadcast stations; but it went on to argue that this "does not mean that the prevailing practices of the networks and their outlets are sound in all respects. . . ." In particular, the FCC believed that some network practices effectively kept competitive program sources, including other networks, from gaining access to the time of a network's affiliated stations. As an outgrowth of its *Report on Chain Broadcasting*, therefore, the commission adopted a series of rules that, among other things, prevented the networks from contracting for exclusive affiliations and restricted their ability to acquire "options" on station time. These chain broadcasting rules were extended to television in 1946 and, with some modifications, still govern the network-affiliate relationship in television. In 1977, however, they were deleted for radio on the grounds that the proliferation of competing radio networks had rendered them obsolete. (Because of that increased competition, for example, radio affiliation contracts were often running for only six months compared to the commission's limit of two years.) Nevertheless, the question asked in the commission's initial notice on the television inquiry, issued that same year, was not whether the rules for television should be eliminated but whether they needed to be strengthened.

This theme—that increased access by nonnetwork sources to station time is intrinsically good and that network practices limiting such access are presumptively bad—has guided the commission for forty years, forcing it into lengthy investigations to determine when a particular network practice is "sound in all respects." The difficulty is that the economies yielded by networking are not exhausted in the provision of a single program. Therefore, determining whether a practice is "exclusionary" or "in the public interest" is not a simple matter.

A network that offers an array of programs that extends across the broadcast week clearly can provide its affiliated stations with greater economies than can the purveyor of a single program. To begin with, the existence of a network permits advertisers to purchase time on a large number of stations and programs in a single transaction, knowing that the ad will appear at the same time in each market. This is obviously less expensive than negotiating contracts with each station individually and also makes it easier for the advertiser to predict the audience it will reach. The network form also permits a network and a station to negotiate a single contract that covers the processes of offer and acceptance and the amount and manner of compensation for many programs, thus reducing costs below what they would be if

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networks offered service on a program-by-program and station-by-station basis. This undoubtedly is why stations tend to acquire most of their programs from a single source. Finally, a network that provides many programs can spread the risk of program failure and thus predict more accurately its rate of success than can a network offering only a single program. With the networks now financing a substantial portion of the cost of program development, spreading the risk across a large number of programs is a considerable advantage.

In short, a strong case can be made that it is economically efficient for networks to offer an extensive array of programs. Although one can imagine instances in which a network might try to exclude potential competitors by offering more programs than required for efficient operation, it is not easy to know when that line has been crossed. Nonetheless, the FCC has adopted rule after rule predicated on the notion that it knows when the line will be crossed, that it can design ways to prevent it, and that the viewing public will be better off as a result.

Regulating Network Contracts

The FCC's ambivalence about networking probably has been sufficient in itself to doom the commission's efforts to reduce network dominance. But two other failures have exacerbated the problem. For one thing, the commission has frequently regulated network behavior on the dubious premise that shifting profits from networks to their affiliates or program suppliers will cure the evils that networks inflict. For another, it has exhibited an almost inexhaustible capacity for devising rules on network dominance that are ineffective, if not downright harmful to the public interest.

Both failings are dramatically illustrated by the "syndication" rule. Adopted in 1970, this rule provides that networks may not share in the off-network rerun (or syndication) revenues of programs produced by independent suppliers for network exhibition. The rule would further the public interest and reduce network dominance, said the FCC, because if the producer does not have to grant a large portion of its potential profit to a network, its ability to operate profitably in network television "will be greatly enhanced," and it can be expected "to develop into a stable and continuing alternate source of programs and ultimately to compete for network time" (*Competition and Responsibility in Network Television Broadcasting*, 1970).

The syndication rule was adopted in response to pleas from program producers that they "deserved" higher profits but had failed to realize them because of the market power of the networks—who, apparently, were bent on slaying their principal sources of supply. This method of defining the public interest, by comparing the just deserts of industry participants, confuses the regulatory issues posed by network dominance because it fails to distinguish situations where the interests of networks, affiliates, and program suppliers coincide from situations where they diverge.

Networking has been a very profitable business, in large part because of FCC-imposed entry restrictions. It is profitable not only for networks, but for affiliates and program suppliers as well. The simple truth is that these three groups are co-venturers no one of which can succeed without the other two. They have a common interest in maximizing the profits to be gained from networking. Where there is disagreement among them, therefore, it will almost always be over the manner in which those profits should be shared. Consequently, when the commission responds to assertions of network dominance by asking how best to rectify damage inflicted by networks on affiliates or program suppliers, it reacts only to controversy over the distribution of profits, the point at which the interests of these groups diverge. The public interest—the interest of viewers in competition among television firms, in the widest possible program choice, and in local control of broadcast services—is not apt to be affected by the outcome of such disputes.

In the proceedings leading to the adoption of the syndication rule, program suppliers had argued, and the commission had concurred, that if profits could be shifted from networks to producers, the latter would compete more effectively with ABC, CBS, and NBC in supplying programs to stations. But even if the rule had succeeded in increasing the producers' profits, it could not affect their incentive and ability to compete in other markets. If producing programs for sale directly to stations is unprofitable, that fact is not changed

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by making sales to the networks more profitable. And it is simply not credible that producers would choose to dissipate any increases in earnings from sales to the networks by undertaking an unprofitable activity. Program suppliers are *not* eleemosynary institutions.

The commission's theory is flawed in another, equally important way. It is highly unlikely, even if a transfer of profits to suppliers would cause them to produce more programs, that regulation of a number of contract terms could produce such a shift.

In adopting the syndication rule, the commission apparently believed that it could prevent program suppliers from agreeing to onerous contract terms that the networks would otherwise impose because of their bargaining power. By contrast, we regard it as virtually a truism that such attempts to rectify imbalances in bargaining power by regulating network contract terms cannot succeed. That approach instructs networks to act contrary to their own interests and therefore gives them every incentive to avoid its intended effect. Moreover, such regulation does not alter the number or identity of network firms, or the structure of the markets in which they operate, and therefore does not diminish the bargaining power that initially gave rise to concern. And that bargaining power will usually enable the networks to alter other terms of the agreement to regain whatever advantage they previously possessed. Thus, for example, our examination of the program supply industry unsurprisingly demonstrated that the complexity of agreements to produce and supply network programs left the networks several alternative methods (including simply lowering the price they paid) to recapture, through different terms, the value of their previous share in syndication revenues.

To assess fully the effectiveness of the FCC's network rules, another (potentially more plausible) basis for regulatory intervention has to be examined. Fearing that the dominant networks might also use their market power to inhibit the entry of additional networks, the commission has tried to prevent such exclusionary behavior. Unlike the attempt to shift profits, this policy is neither illusory nor unrelated to the public interest. Almost without exception, however, the target has been the established networks' success in dominating their affiliates' program schedules, rather than the danger that those networks would prevent the emergence of additional full-time networks employing other outlets.

. . . the target has been the established networks' success in dominating their affiliates' program schedules, rather than the danger that those networks would prevent the emergence of additional full-time networks. . . .

Assuredly, ABC, CBS, and NBC have every incentive to prevent further network entry. However, because networks exist only as middlemen among viewers, advertisers, program suppliers, and local broadcast outlets, they can achieve such market power only by monopolizing one or more of these groups. It is quite simply inconceivable that the dominant networks could, through contract or merger, acquire control over enough viewers, advertisers, or program suppliers to affect the prospects of potential networks. It is, however, true that broadcast outlets are limited. The networks conceivably could deter entry by paying these outlets to deny other networks access to them. Such foreclosing tactics can be prevented, however, by forbidding any network firm to obtain control, by ownership or agreement, of sufficient outlets within any local market to enable it to monopolize distribution.

This could be done in most cases simply by applying elementary and widely accepted antitrust principles. But the FCC's network rules, rather than reflecting such understandable proscriptions on the horizontal acquisition of network market power, have involved endless tinkering with the terms of network contracts. The effort has been futile, because the fundamental economics of program production and distribution give networks an overwhelming advantage in any event. And it has been wrongheaded, because the effect has been to inhibit the adoption of efficient arrangements.

For example, from the inception of television networking the FCC has banned the practice known as "option time," whereby networks once acquired guaranteed access to certain parts of their affiliates' broadcast day. But the ban does not improve the prospects for new

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networks because option time did not foreclose access to other outlets that a would-be competitor might employ. Nor does the ban substantially improve the ability of non-network sources to sell their programs to affiliates, because it leaves the networks free to structure other terms of the affiliation contract so as to affect the carriage of network programs. One method networks use is to increase the hourly compensation paid to stations for carrying network programs as the total number of hours carried increases; another is to vary the advertising time available for sale by stations within or adjacent to network programs. In other words, what the ban has done is to force networks to use less efficient means, such as graduated compensation plans, for achieving the goals that they formerly achieved through option time.

Since the chain broadcasting rules and the prime time access rule do nothing to reduce network market power or provide benefits to the public, we urge their elimination. This recommendation has been opposed by public interest groups and some industry participants—but, curiously, not on the grounds that our analysis is incorrect. Their position appears to be that "doing something," even if it is ineffective, is better than doing nothing at all.

Commission Policies and the Entry of New Networks

One reason we are so critical of attempts to attack network dominance by regulating contractual practices is that, whatever the benefits of such regulation, other policies would have produced much more significant change. We submit that no one would care how much of a station's time were occupied by a single network if the number of stations and networks were very large. Indeed the commission itself seemed to be operating on this principle when it eliminated the network-affiliate regulations for radio. Even the most ardent advocate of the present television network rules must agree that the only possible way to reduce the market power of ABC, CBS, and NBC and, more important, to expand the range of choice available to viewers is to eliminate barriers to the creation of new networks. Yet during the entire period from 1946 through the mid-1970s, the commission, while claiming to be concerned with network dominance, was pursuing in a more or less systematic manner policies that were cementing that dominance.

The spectrum allocation plan for television adopted by the commission in 1952 guaranteed that there would be no more than three over-the-air television networks for a very long time. This is so for two interrelated reasons. First, instead of allowing stations to serve wide geographic areas, the plan limited coverage so that many stations were assigned communities too small to support more than one or two stations. Second, the plan, which allocated portions of both the VHF and UHF bands for the broadcast of television signals, "intermixed" VHF and UHF stations—that is, it frequently assigned both types of stations to the same market. UHF, then and now a technically inferior service, suffers a handicap in competing in such intermixed markets. Since the plan provided that a very large proportion of viewing households would be able to receive a fourth commercial television station, if at all, only on UHF in an intermixed market, it put a potential fourth over-the-air network at a significant competitive disadvantage. The combined effect of these policies has been to make a fourth network unprofitable, although such a network almost certainly would be profitable if it could obtain coverage equivalent to that of ABC, CBS, and NBC.

Significantly, the commission did little over the years to undo the effect of these early decisions. In the late 1950s it began a set of proceedings designed to "deintermix" certain markets so that UHF stations would compete only with UHF stations. After creating a small number of such all-UHF islands, however, the FCC abandoned the policy under congressional pressure. At about the same time, the commission began to restrict cable television, a competitive technology that emerged, in part, because of the limited over-the-air service available in many markets. Had cable not been restricted, it might have been possible for other networks, composed of broadcast stations in some markets and cable systems in others, to compete with ABC, CBS, and NBC. If the FCC had permitted cable to carry signals of independent broadcast stations into markets served only by three stations, the handicap created for a fourth network by the limited coverage avail-

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able to it and the fact that many of its affiliates would have operated in the inferior UHF band might have been overcome. It was only after the distant-signal carriage rules were relaxed in the early 1970s that such a network could come into being.

Until recently, the commission also made it difficult to create networks financed by direct viewer payments (pay-TV) instead of advertiser support. The principal means employed were "anti-siphoning" rules, which limited the amounts and types of movie, sports, and series programs that pay-TV could provide to its viewers. These rules were supplemented for over-the-air pay television (STV) by restricting the number of such stations that would be licensed and the portion of the broadcast day during which pay-TV could be offered.

With each of these policies, the commission limited the ability of new networks to enter the market, sacrificing potential improvement in network competition in order to achieve some other goals. In no case, however, have these other goals been realized. Even after almost three decades of commission attempts to foster the growth of UHF television, relatively few of the stations allocated have come on the air and those that have still suffer under a considerable handicap. Moreover, there is no new over-the-air network making large-scale use of UHF affiliates on the horizon, despite evidence that an additional over-the-air advertiser-supported network comparable in size to ABC, CBS, or NBC and with the same proportion of UHF affiliates in intermixed markets would probably be viable. The constraints imposed on cable TV in order to preserve the over-the-air broadcasting system provided few benefits to that system while imposing substantial costs on viewers, as the commission now concedes. Finally, all the available evidence indicates that the restrictions on programs that could be offered by cable systems for a fee reduced rather than expanded the range of choice available to the public.

With each of these policies, the commission . . . [sacrificed] potential improvement in network competition in order to achieve other goals. In no case, however, have these other goals been realized.

Fortunately, much of this has begun to change. The multipoint distribution system (MDS) has become a potential source of TV service to the home as a result of the commission's 1970 decision to increase its bandwidth to 6 megahertz. In 1978, the year after a federal court found the restrictions on pay cable to be without substantial foundation (*Home Box Office* v. *FCC*), the commission eliminated its anti-siphoning rules for both pay cable and STV, an action that is stimulating the growth of a number of networks distributing pay-TV using cable systems as local outlets. Last year, the commission deleted its remaining distant signal carriage rules for cable television. This action, if upheld in the courts, will free cable systems to pick up and use the signal of any broadcast station and will benefit the growing number of networks that provide satellite interconnection for cable systems carrying the signals of major independent television stations. (See Henry Geller, this issue, page 35.) Also in 1980 the commission began to accept applications for a very large number of newly authorized low-power television stations. A number of these applicants say they intend to link these stations by satellite and provide either pay-TV service or programs that appeal to geographically dispersed households with similar interests.

These policies have substantially improved the prospects for would-be networks. But more needs to be done. In a follow-up to our report, we have recommended to the commission that it eliminate its rule restricting STV stations to markets where there are at least four operating advertiser-supported stations; that it assign additional spectrum space to MDS service; that it adopt the proposal put before it over five years ago to authorize a number of new VHF stations that would operate at higher power than the new low-power service but at lower power than present stations; and that it not restrict the proposed direct satellite broadcast service out of concern about its effect on broadcasting. These measures would do much to undercut the three-network dominance of the industry, an objective the commission has pursued diligently, but ineffectively, for more than three decades.

Even if these recommendations are shunned, however, the changes occurring in

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television will continue. Too many irreversible reforms are now working their way through the industry for it to remain for long a system dominated exclusively by three networks. The principal effect of not adopting our recommendations will be to alter the form that change takes, not to prevent change from happening.

If, for example, the commission fails to eliminate barriers to the creation of networks of STV stations, the result is likely to be more rapid growth of pay television over cable. If the commission fails to authorize a direct broadcast satellite service, some other technology, perhaps MDS, will grow more rapidly. If the commission fails to authorize additional broadcast stations, the result is likely to be more rapid growth by cable. And if all are rejected, it should make the producers of videodiscs and videocassettes, which are outside the control of the regulators, very happy indeed.

Conclusions

A question that continues to puzzle us is why the FCC has engaged in the sort of mis-regulation recounted above. Part of the answer seems clear. The familiar principle that regulators are loath to take back benefits once granted explains why the commission did not deal with network dominance by moving against the entry barriers confronting new networks. In 1945, the commission determined that, although television should ultimately be confined to the UHF band, some VHF allocations should be made available immediately in order to permit commercial television to develop. Three years later, when it became apparent that the geographical allocations adopted in 1945 would not work, the commission "froze" all pending TV station applications in order to develop a new allocation plan. That freeze, expected to last only six months, was not lifted until the current plan was adopted in 1952. But by then 108 VHF stations, those fortunate enough to have received authorizations before the freeze, had come on the air. The 1952 allocation plan did not affect a single one of these 108 licenses. Indeed, it was apparent that the commission allowed the existence of these licenses to tie its hands as it was establishing the framework for the national TV system. As a result, television came to be limited to a three-network system.

Later, the commission thwarted new technologies, such as cable, and alternate financing methods, such as pay-TV, on the grounds that their development might undermine the television system established by the 1952 plan. In this truly perverse fashion, the "temporary" decision of 1945 spawned its own vested interests, and the preservation of the system it had created became the determinant of commission policy.

But if there were exactly 108 reasons for the FCC's failure to take actions that promised to erode dominance by the three networks, what explains its repeated promulgation of ineffective regulations aimed at network power? To be symmetrical, it could be argued that the network rules were designed to give the illusion of progress while deflecting attention from the real causes of network dominance. For those who have studied those proceedings, however, such an argument gives the commission far too much credit. To be sure, frustration is part of the explanation. Undoubtedly the rules stemmed in part from a sense that something had to be done about the networks. But at least equally important, we think, was simply a failure of analysis. Unaware of the fundamental economics of networking, confused by assertions that redistribution of private profits would serve the public interest, uninterested in evaluating the empirical results of its rules, the FCC spent over thirty years adopting doubtful solutions based on dubious premises. ■

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The Copyright Controversy

MAKING CABLE TV PAY?

Henry Geller

FORMER SENATOR WARREN MAGNUSON once observed: "All that each industry seeks is a fair advantage over its rivals." Nothing better illustrates that point—or the politicians' difficulty in withdrawing advantages they have bestowed—than the current controversy over cable TV and its statutory license to carry TV broadcast programs.

Competition is coming strongly and swiftly to television markets long the sole preserve of the VHF broadcaster: UHF broadcasting, including subscription TV, is thriving. New low-power operations are being planned by the thousands. Multipoint distribution systems are carrying pay-TV programs into homes. Cassettes and discs are becoming an alternative means of delivering film fare. The Federal Communications Commission (FCC) has just cleared the way for the possible entry into the television market of direct broadcast satellites by the mid-1980s. Most significant of all, cable television is expanding rapidly in the major markets. Now in about 23 percent of the nation's TV households, it is expected to reach 50 percent by the end of the decade. These new cable systems—which can carry 100 or more channels of TV programming, compared to 12 for traditional cable—represent a true television of abundance.

But all these technologies are no more than delivery systems. What is important to the viewer—and central to my subject here—is the programming they deliver and the method for compensating the copyright owners who supply that programming.

One would have thought that all television delivery systems would purchase their programming fairly in the marketplace, with the government showing no favor to any of the competitors. That is indeed so, except in one case. The government favor is not for one of the new struggling services, like low-power TV or videodiscs. It is, instead, for the fastest growing service of all, cable—a multi-billion dollar industry that includes corporate giants like Westinghouse-Teleprompter, Time-Life, Warner–American Express, and Times-Mirror. Under the Copyright Act of 1976, cable enjoys a government-provided license to carry any TV broadcast signal it desires (subject to FCC rules) and to do so at government-set rates. This gives cable an important financial advantage and some advantages of other sorts as well. For example, while TV broadcasters—commercial or subscription—can be denied the right to a sporting event because of valid league regulations, cable can bring in the same event from distant stations because of the compulsory license. (Unless—as sometimes happens—broadcasters are refused carriage of an event because the sports entrepreneur does not want cable to pick it up "off the air" for relay to other areas.)

Why is it that government intervenes so massively in the TV programming market in favor of cable? To answer the question, we

Henry Geller, director of Duke University's Washington Center for Public Policy Research, formerly headed the National Telecommunications and Information Administration (1978–80).

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must first know some background on the industry and the 1976 act.

The Copyright Act of 1976

Cable systems carry over their wires not merely the programming of local TV broadcast stations, but often the programming of distant stations, taken "off the air" and transmitted across the country by microwave or satellite. Of course local broadcasters do not mind when a cable system carries *their* signals; in fact, they would like it to be compelled to do so (and the FCC has obliged by imposing such a requirement) since that increases their audiences and thus the rates that advertisers are willing to pay. However, signals from stations in another market (so-called distant signals) are a different matter; they fragment audiences and ultimately reduce the advertising revenues the broadcasters' air-time can fetch.

Up to a point, the interests of the copyright owners coincide with those of the broadcasters. One of the benefits that a copyright confers is the ability to grant reasonable *exclusive* performance rights in a particular area. And programs whose exclusivity is guaranteed naturally bring a higher price to the copyright owner, since the purchasing station can promote the program secure in the knowledge that it alone will derive the benefit of its promotion.[1] But of course the copyright owner cannot guarantee exclusivity if a performance of the same program in a distant market can be "piped in" by cable. As far as the copyright law was concerned, that was the situation prior to 1976. The Supreme Court had held in *Fortnightly Corp.* v. *United Artists Television, Inc.* (1968) and *Teleprompter* v. *Columbia Broadcasting System, Inc.* (1974) that the retransmission of broadcast signals taken "off the air" did not constitute a performance under the 1909 Copyright Act, and thus could not be prevented by the copyright holder. This put the rapidly growing cable industry in the happy position of being able to use programming produced and financed by somebody else without having to pay for it.

The inequity of this arrangement was apparent, and Congress responded in 1976 by amending the copyright law. The amendment did three things: First, it declared retransmission to be a performance and thus, if unlicensed, a violation of the copyright. But then it granted cable systems an automatic "compulsory license" with respect to all locally broadcast signals and with respect to those distant signals that the cable systems were permitted to carry by the FCC. Finally, it established that the fees payable to copyright owners for this license would be based on a percentage of each cable system's gross revenues from TV distant signal carriage and would be adjusted periodically by the Copyright Royalty Tribunal (CRT), an agency created by the 1976 law. (Not surprisingly, the CRT process—which involves not only determining the periodic adjustment, but also dividing up the total "pot" among the various copyright claimants—has been most difficult, enriching squabbling lawyers but often not their clients.) The fee specified in the act was, of course, less a reflection of "real value" (if that term has any content apart from a free market) than of the political strength and negotiating position of the interests involved. As to political strength, the broadcasters and copyright owners were a fairly even match for cable. However, by reason of the Supreme Court's holdings that no copyright protection currently existed, their negotiating position was disastrous—since there would not be any royalties unless legislation was passed. It being easier to stop legislation than to pass it, the cable interests had the whip hand. In short, the fee was laughably low.[2]

Copyright owners did, however, have some protection in that the compulsory license was granted only for programming that the FCC permitted cable to carry. And at the time, the FCC's rules contained two significant restrictions: the first limited the number of distant signals that a cable system could import, and the second guaranteed "syndicated exclusivity" —meaning that if a local TV broadcaster had paid a copyright owner for the exclusive right to show a program in the area, the cable system had to "black out" that program when it ap-

[1] The programs referred to here are not the ABC, CBS, or NBC programs (for such fare is distributed for simultaneous nationwide viewing), but are, rather, the non-network films and series, often called syndicated programming.

[2] In 1979, for carriage of non-network distant signal programming, copyright owners received $15 million from cable via the CRT—about 1 percent of the industry's basic revenues—compared to $1,343 billion from TV broadcasters—equal to 30 percent of gross broadcast revenues (excluding network sales).

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peared on any distant signal the system was carrying.

The rationale for all this was that it would be "impractical and unduly burdensome" to require every cable system to negotiate with every copyright owner whose work it was going to retransmit. Perhaps so. But the approach taken in the Copyright Act was badly mistaken. If Congress felt compelled to establish a compulsory license, it should at least have limited the damage by distinguishing between the traditional and the new cable systems. Traditional twelve-channel cable had been operating in relatively small markets for years, relying heavily on distant signals for its success. To have subjected these firms to full copyright liability would have disrupted long-established program schedules and viewer habits in towns and small cities across the nation. Further, the copyright owners would have gained little, for they receive less than 10 percent of their revenues from smaller markets (the 100th largest on down to the smallest). It therefore made good political sense for Congress not to alter traditional cable's right to distant signals.

But the new cable systems were a different creature, and should have been required to fend for themselves in the programming market. Even in 1976, they were not "Mom and Pop" operations; rather, they were large corporate enterprises offering thirty or so channels to viewers in major markets and capable of spending the $80 to $100 million it takes to "cable" a big city. More important, they were beginning to penetrate these major markets (where there already is a great deal of over-the-air TV programming) by relying not on distant TV signals, but on original programming distributed via satellite.

From Bad to Worse

Since 1976, cable has become a major industry. The capacity of the new systems has grown to 50, 100, or even more channels. The industry includes seven pay-TV networks with satellite distribution reaching close to nine million subscribers, and more are planned. Moreover, the success of pay-TV had led to the development of advertiser-supported cable networks, which

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now include two sports networks and five networks offering more general programming, with several more in the offing. All of these provide signals to the cable systems via satellite, without charge (and one of them even pays cable to carry its programs). The industry also includes "hybrid" networks which supplement advertising revenues by charging cable systems a monthly subscriber fee. And finally, there are free information networks, free religious networks, and special children's services. In short, the industry has grown enormously in diversity, sophistication, and financial power.

Thus the Copyright Act, seriously flawed policy even at its inception, is wholly bankrupt today. Yet until 1980, at least the FCC's rules on distant signals and syndicated exclusivity somewhat alleviated the inequity to copyright owners. But in a 4–3 decision last September, the FCC eliminated those protections and proclaimed, with a burst of deregulatory enthusiasm, that it was freeing cable to operate in the marketplace.

That assertion calls to mind George Orwell's admonition on looking behind the shibboleths for the substance. What the FCC has done is deregulatory only in the limited and parochial sense that the agency has lifted its own major rules governing cable. In doing so, however, it has not thrown the industry into the free market but placed it more fully than before in the hands of another regulatory system, the copyright tribunal.

If the FCC's decision is sustained, there will no longer be any effective way for a broadcaster to purchase a temporary exclusive right to desirable programs. Thus it will not be possible for copyright owners to earn larger revenues on programs in high demand—new films, for example—by offering full exclusivity in a number of different markets. Instead, their first sale of a new film to a broadcaster can be, in effect, a nationwide sale (because of satellite carriage to the cable universe), and the fees due from cable will be determined administratively at the CRT. In short, all programming on the air—not just some of it, as in the past—will be subject to cable's compulsory license. And presumably, in an effort to maintain control of their product, sports entrepreneurs in particular will increasingly tend to sell only to cable. Finally, the CRT's fee-setting operation will be larger and more complex than before.

It is not surprising that the FCC's action has aroused a storm. In essence, the agency has eliminated what many had understood to be an essential part of the government-prescribed payment formula. As former Register of Copyrights Barbara Ringer told the Senate Judiciary Committee on April 29, it was assumed when the Copyright Act was passed "that the FCC might tinker with its rules but that it would not completely abandon the protection it offered copyright owners." With that assumption now gone, the cable copyright matter is before Congress once again.

The Congressional Debate

Simply put, there are essentially three alternatives for Congress to consider—(1) leave the situation where it stands, (2) reestablish by law the rules eliminated by the FCC, or (3) build on the FCC's action by dismantling the remaining (and most offensive) part of the regulatory structure governing cable copyright. In each case, the cable TV industry is pitted against the copyright owners, the sports leagues, and the other commercial delivery system—broadcast TV.

Accept the Status Quo. This alternative is of course the one the cable systems prefer. They, along with former FCC Chairman Charles Ferris, insist that copyright owners will be justly compensated under the new system. In defending this position, they rely on an FCC economic analysis "proving" that the rescission of syndicated exclusivity will not adversely affect the revenues the copyright owners receive from sales to television broadcasters—while adding that, in the unlikely event it should do so, this could always be offset by an increase in the CRT's royalty fees.

The argument is protectionist, brazenly bureaucratic, and utterly beside the point. To begin with, such a fee increase would be a ham-handed approach to compensating copyright owners. By what intricate formula could the CRT hope to divide the pot fairly? But the main point is that there is a long-established market in copyrighted program sales, that this market functions well, and that cable TV, like all other TV distribution systems, should have to operate in that market. Can anyone doubt how Congress would react if the National Tele-

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communications and Information Administration recommended, based on a study, that RCA and other disc entrepreneurs be granted a compulsory license to use films as they saw fit? Economic studies, however valuable they are in other contexts, are wholly irrelevant here. If cable carriage of non-network programs from distant stations does not have an adverse effect on copyright owners, the market will reflect that over time, and a superstation (whose operation is designed for nationwide cable distribution via satellite) will be able to obtain the programs they require at no extra charge. If on the other hand, as I suspect, it does have an adverse effect (particularly as cable penetrates more deeply into the major markets), the market will reflect that also. Either way, pricing decisions on copyrighted material are not the government's business.

Cable also asserts that, as the broadcast stations receive higher advertising rates because of the increased viewership they gain through cable, the copyright owners will be able to demand higher fees. This might not happen in the case of "unwilling superstations" (for example, WGN or WOR) since they use local advertising in substantial part, and the merchants in New York obviously will not pay for ads shown in Ohio. But a "willing superstation" (for example, WTBS-Atlanta) could avoid local advertising and therefore probably might adjust its advertising rates (and copyright payments) to reflect its increased viewership. But, here again, this simply establishes that the market will work and that there is no need for the government to intervene.

Not surprisingly, the Copyright Royalty Tribunal also likes the new arrangement. On April 29 the CRT—but not its then chairman—told the Senate Judiciary Committee that it was not "aware of any changes in copyright clearance procedures that provide justification for altering the judgment of the Congress that a cable compulsory license is necessary." CRT is making the old argument that if a cable system in Ohio wants to carry a distant signal like WGN-Chicago or WOR-New York, there is still no practical way for it to do so under full copyright liability: how can the Ohio system bargain for the right to carry every one of the hundreds of programs on WGN or WOR? The CRT's argument is entirely correct and entirely irrelevant. With a plethora of programming available to cable via the many satellite services, why should Congress make WGN's or WOR's programming available to cable by compulsory license, with government-prescribed fees? Why should it skew the market process?

Reverse the FCC. On May 13, Rep. Robert Kastenmeier (Democrat, Wisconsin), chairman of the House Copyright Subcommittee, introduced a bill (H.R. 3560) to limit cable's compulsory license to signals allowed to be transmitted under the FCC's former distant signal and syndicated exclusivity rules (with systems having fewer than 5,000 subscribers exempted from copyright liability). Essentially, the bill aims to quiet the controversy by reestablishing in law the protections originally underlying the 1976 act. The difficulty with this approach is twofold: as the cable industry grows, so does the impropriety of the privilege government has bestowed upon it; and the longer the privilege exists, the more difficult it is to withdraw.

The Sensible Solution. Clearly, the Copyright Act was and is bad policy. There is no need for the distant signal rule or the syndicated exclusivity rule or the compulsory license or the CRT. There is need for only one provision—full copyright liability for all cable systems operating in the major markets. At the outset of the congressional debate, few seemed prepared to go that far. By now, however, full copyright liability has strong support—from the Department of Commerce, Register of Copyrights David Ladd, and former CRT Chairman Clarence James, among others. And on May 12, Rep. Barney Frank (Democrat, Massachusetts) introduced a bill (H.R. 3528) that would establish such liability effective January 1, 1983, with an exemption for systems serving fewer than 2,500 subscribers. A slightly different way of achieving the same objective would be to require that new systems or new signals in the large markets—say, the 100 largest—come under full copyright liability immediately and that existing systems in those markets do so after one year, while providing an exemption for all systems in the remaining smaller markets.[3] Either

(Continues on page 58)

[3] This approach differs from Rep. Frank's in one small respect: I suggest a market-size cutoff in preference to a subscriber cutoff, so as to avoid the difficulty of a cable system's coming within full copyright liability just because it has added one more subscriber.

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The Uncertain Course of Bank Deregulation

Kenneth E. Scott

In many quarters there is a belief—be it hope or fear—that a mood of deregulation is sweeping the country. A prime candidate for such a movement would certainly be the banking business—one of the first industries in the United States to be regulated and by now probably the most thoroughly and extensively regulated of all. And in fact 1980 did see the enactment of the Depository Institutions Deregulation and Monetary Control Act. That title is something of an exaggeration, however, and the prospects for deregulation in the banking business are far from clear.

Most of the intricate mass of bank regulation is left quite untouched by the 1980 act. The cumbersome and outmoded tangle of provisions dealing with portfolio regulation is preserved intact. Truth-in-lending was simplified, if that is the proper word, by another twenty pages of statutory enactment. And reserve requirements were extended to all banks and to thrift institutions (mutual savings banks and savings and loan associations) in the most sweeping expansion of federal regulation in that domain since 1913.

What the 1980 act does represent is a dismantling of the anticompetitive cartel structure that was created by the Banking Act of 1933. The Banking Act, in a manner consistent with the economic thinking that characterized that period, sought to deal with the problems of the depression by creating an industry cartel to divide markets and fix prices, in the name of preventing that excessive competition which was seen as the major cause of business failure and economic depression. In essence, the Banking Act of 1933 undertook to create a buyers' cartel among banks, restraining competition among them for demand deposits and for time and savings deposits. Under the cartel the maximum rate of interest payable for time and sav-

Kenneth E. Scott is professor of law at the Stanford Law School and senior research fellow at the Hoover Institution.

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ings deposits was to be established through the regulatory agencies, the Federal Reserve Board, and the Federal Deposit Insurance Corporation (FDIC), while the maximum rate to be paid on checking accounts was fixed in the law itself, at zero. The 1980 deregulation act memorializes, more than anything else, the collapse of this cartel.

I

Under Title II of the act, the interest ceilings on time and savings deposits, commonly known as Regulation Q, are to be phased out over a six-year period. In the findings and purpose clause, Congress purports to discover for the first time that interest rate ceilings discourage persons from saving money, create inequities for depositors, impede the ability of depository institutions to compete for funds, and have not achieved their purpose of providing an even flow of funds for home mortgage lending. Most economists and other students of the subject, of course, had discovered all that some decades ago. On its face, Congress has decided as a matter of principle to stop penalizing smaller savers and to start encouraging capital formation, and has brought to an end its recent policy of trying to make savers subsidize home mortgage borrowers.

Why did Congress take this step in 1980? It is not, I would suggest, because its members gained economic insight previously denied them. Instead, it is because the buyers' cartel created by the Banking Act had largely disintegrated, and for the usual reasons. Cartel members have a laudable tendency to cheat on each other by deviating from the established price. In this case, they have been offering premiums and finder's fees and free services for years. Along with fixing prices, cartel members have to agree on a division of the market, and that is always a fertile source for disputes and infighting and ultimate breakdown. In this case, the fighting between banks and savings and loan associations over the role of the differential (between the ceiling for bank savings deposits and the quarter-point higher ceiling for S&L savings accounts) and their respective market shares has become ever more intense. In addition, price-fixing arrangements cause a cartel to lose customers to firms that are outside the cartel and can pay market prices. In the banking business, this phenomenon was seen first in the salutary process known as disintermediation (as depositors withdrew funds to invest directly in the capital markets) and then in the rise of new intermediaries outside the cartel—money market funds in particular. When enough of the cartel members conclude that their arrangements are no longer beneficial, they will break up. Since this cartel was originally achieved through legislation, its breakup takes the form of a repeal of that legislation.

But the outcome here is not yet free from doubt. Some members of the cartel hope that it can still be patched up—that the dissidents can be forced back into line, that the controversy over the differential and market shares can be resolved, and that outside competitors such as money market funds can be brought under control or forced into the cartel also. On the one hand, Title II calls for the elimination of Regulation Q, but on the other hand, it extends rate control authority for six years—the longest extension it has received since the new era of 1966 when S&Ls, which were then outside the cartel and had been vigorous competitors, were brought within the cartel by legislation.

The 1980 bank deregulation act memorializes, more than anything else, the collapse of the anticompetitive cartel structure created by the Banking Act of 1933.

Though it is under severe strain, therefore, the savings account cartel is not yet definitively broken, and the struggle continues. The S&Ls want to preserve their rate differential, which is why the banks have concluded that on balance they want out of the cartel. At the very least, the S&Ls would like to shift the phase-out regulatory authority from the Depository Institutions Deregulation Committee, where their representative is in a minority, to the more favorable setting of the Federal Home Loan Bank Board acting alone or through a veto. Both the banks and S&Ls agree that the money market funds should be hobbled, because the funds are paying market rates to smaller savers—the sup-

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posed objective of Title II. "Housing," of course, serves in its customary role as the rationale for all of this.

The second major feature of the 1980 act was the authorization of nationwide NOW accounts in Title III, otherwise known as the Consumer Checking Account Equity Act. The enactment of this title commemorates the well nigh total collapse of bank control over checking accounts. Back in 1933 banks had a legal monopoly over checking, so that when the Banking Act of that year fixed the rate of return on checking accounts at zero, there were no firms outside the cartel in a position to undermine it. But the product monopoly eroded over time, as other financial institutions developed close substitutes for checks, which they proceeded to do when it became highly profitable. Checking account balances became very valuable when market interest rates started climbing well above the old 2 to 4 percent levels that characterized much of the period from 1933 to 1964. From the late 1960s through the 1970s, market rates moved to ever higher levels, and other financial institutions started devising ways to attract checking account business. The mutual savings banks came up with negotiable orders of withdrawal (NOW) as a device for converting savings accounts into a species of checking account, and in 1972 won a court battle over its legality. In the last years of the 1970s, the S&Ls started offering bill-paying services and affording immediate and easy access to savings account balances through remote service units, while credit unions devised share draft accounts and money market funds began making withdrawal orders or pay-through drafts available to their customers also. All of these check substitutes have one element in common—they pay a higher rate of interest than zero. In an attempt to hold their market shares against such competition, banks developed automatic transfer services and zero balance checking, with the approval of their regulatory authorities.

By the end of the decade, this aspect of the 1933 cartel was in ruins: banks no longer had a monopoly on checking accounts, and there was widespread payment of interest on checking account balances. The U.S. Court of Appeals for the District of Columbia Circuit, with its usual economic acumen, briefly propped up the crumbling cartel by its 1979 decision in *ABA* v. *Connell*, which invalidated the entire decade of financial innovation. But the weight of political force was now outside the cartel, and Congress overturned the court of appeals' decision in Title III of the 1980 act, by authorizing all of the various substitutes for checks and extending NOW accounts nationwide. Thus, in substance if not in technical form, the prohibition against paying interest on demand deposits was repealed in the 1980 act for individuals (though not yet for businesses).

II

It should not come as a surprise that the 1933 bank cartel disintegrated, for cartels are inherently difficult to maintain, but one may still ask why that occurred in 1980 rather than earlier or later. One can seek explanations on many different levels, ranging from the vagaries of political personalities and end-of-session maneuverings to broad trends that work throughout the economy. The latter are the more relevant to my inquiry here, and I want to emphasize two major forces.

The most important single factor bringing matters to a head by 1980 was the Federal Reserve Board's conduct of monetary policy and the resulting inflationary swings over this decade that drove nominal interest rates first to the 10 percent and then to the 20 percent level. To put it another way, the effect of inflation is to drive down the real interest ceiling that is imposed by a fixed nominal rate, such as 5¼ percent or 0 percent. The ceilings become negative in real terms, so that depositors are paying the depository institution to take their money. So when nominal interest rates are going up, fixed ceilings become ever more costly to depositors. Concomitantly, there are created strong financial incentives to find a way around the ceiling. That is precisely the situation that characterized the decade of the 1970s, and in particular the last two years.

Second, the destruction of the cartel was assisted by another development that started to be felt in the 1970s—namely, the technological advances that are lumped under the acronym EFT (electronic funds transfer). The products and markets of depository institutions, like those of any industry, reflect existing technology. As the production costs of banks

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and the access costs of their customers change, so will the structure of the industry.

For example, branching was not an important issue in nineteenth century banking. Some banks had branches, but most did not, and nobody much cared. The subject was not even mentioned in the National Bank Act of 1864. There was no particular advantage to branching, beyond a small distance at most, at a time when communication and travel were slow and expensive. That state of affairs changed beginning around 1910 and especially after 1920, under the impact of the telephone and automobile. These technological advances lowered transportation and communication costs for banks and their customers and thereby expanded banking markets and increased scale economies in banking.

The electronic and computer revolution that began after World War II and accelerated in the 1970s is having a similar impact. Geographical markets in banking have again expanded and economies of scale have again increased. These technological advances have helped destroy the product monopoly and market division structure created by the Banking Act of 1933. Non-banks can offer demand deposit and check substitutes over a wide area through EFT networks, consisting at this point mostly of automatic teller machines (ATMs). The Federal Home Loan Bank Board has facilitated this process by encouraging the deployment of remote service units.

III

Against this background, what may we expect in the 1980s? Predictions are always hazardous. The most dismal part of the dismal science of economics is its forecasting record, and certainly lawyers can claim no comparative advantage in this exercise. Let me plunge ahead, however, exploring the implications of two premises. First, the economic trends of the 1970s have not yet spent their force or had their full impact. Second, the provisions of the 1980 act become a new factor, which will have its own effects.

Beginning with the first, should we regard high and volatile rates of inflation as a thing of the past, to disappear under the new administration and the new Federal Reserve Board? Perhaps, but we have heard those claims before. What if the future is like the recent past? It is clear that enormous strains are being placed on thrift institutions, with their inherent imbalance between the maturity structures of their assets and their liabilities. Two types of responses are to be expected: (1) For some time there have been efforts to reduce that maturity imbalance, by affording thrift institutions more short-term assets and more long-term liabilities. Indeed this trend is visible in the 1980 act itself. Title IV allows federal S&Ls to invest in consumer loans, commercial paper, and corporate debt securities. These measures are economically sound and desirable, but bit by bit they move thrift institutions from being an intermediary confined to housing investments to being more of a broad-spectrum financial intermediary. Since that undermines its proven formula for political success, the thrift industry is less than wholeheartedly enthusiastic about such measures. (2) Efforts are being made to shelter thrift institutions from the forces of competition or to obtain subsidies for them, at the expense of savers or taxpayers. Examples are the industry's drive to hamper money market funds, to maintain or enlarge its rate differential, and to obtain an increased income tax exemption for savings account interest. It is all supposed to be justified in the name of helping housing or helping the poor, even if the supporting arguments and evidence seem thin. There is very little reason to believe that deposit rate ceilings result in lower

Drawing by Leo Cullum; © 1977 The New Yorker Magazine, Inc.

"Mr. Arnold, this is Buddy, in Small Loans. Can we spare a dime?"

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borrowing costs for home buyers, for example, and even if they did, it would be a grossly inefficient way to help the poor. What rate ceilings do ensure is that the poor shall not earn market rates on savings. But in Congress, it does not matter if the arguments do not hold up, so long as the political coalition does.

Both types of efforts serve the interests of thrift institutions, and no doubt the industry will try to have it both ways—seeking expanded investment authority and greater fund-raising flexibility, while also seeking legal shelter from competition and various forms of government assistance in the name of housing. But in the long run, the first strategy undercuts the second, as it takes thrift institutions more and more in the direction of being a general intermediary and away from being a mere housing prop. A continuation of this process should ultimately lead to the dominance of the first strategy, which is the only way the thrifts can overcome their structural unsoundness.

The other economic force that I mentioned was the growth of EFT technology. So far, we are not even close to realizing the full potential of EFT. There are in place relatively small networks consisting of dozens or hundreds of ATMs, but the maximum savings from this technology will come from networks consisting of thousands of point-of-sale (or even home) terminals. As this evolution continues, scale economies and geographical banking markets are again being increased. The remaining pieces of the old bank cartel—the barriers to competition in natural market areas—will come under increasing assault. Unit banking laws, and the notion that there is something terrible about bank competition across state lines, seem sure to be effectively undermined or completely eliminated before the decade is out.

Adding to these economic forces will be the effects of the 1980 act itself. A number of its features point toward more competition and lower profits for the isolated or monopoly bank. As we have noted, the checking account monopoly of banks has ended de facto if not de jure; S&Ls, mutual savings banks, and credit unions have now entered the field, while money market funds, brokerage firms, and national retailers are poised on its outskirts. At the same time, the ban on the payment of interest on demand deposits has also ended, except for business deposits. (The latter prohibition was never really significant, since it was more easily circumvented. But even this last remnant of the interest prohibition is not likely to survive.) The natural geographic market areas for banking services are expanding, which means more competition from other banks, as well as from S&Ls and credit unions which are not hobbled by a counterpart of the branching limitations imposed on national banks by the McFadden Act. Small state banks in particular, which have historically not been members of the Federal Reserve, will now experience a new tax through the form of the mandatory reserve requirement imposed on them by the 1980 act. All of these factors will come together with increasing force, bearing particularly upon those banks that have heretofore been the most sheltered from competition.

The 1980 act also brings S&Ls into a much more competitive environment. The protection afforded them by interest rate ceilings and their cherished differential are on the way out, or so we are told. Their investment powers are increased, but the markets that they will be entering are already in most instances highly competitive. And their forays into the world of transaction accounts will now likewise be burdened with a reserve requirement. Meanwhile, inflation has devalued their mortgage portfolios, creating solvency problems quite apart from the effects of Regulation Q or its elimination.

IV

When one puts this all together, what impends? Some major trends seem clear. First, our artificially balkanized banking structure will move toward a more efficient configuration, with fewer firms, of substantially larger average size, operating within natural market areas. That does not mean that small banks will vanish or that only a handful of giants will survive. It does mean, however, that many existing firms will disappear. The nonprice competition for deposits that has marked much of the last two decades has led to overinvestment in branch capacity for many institutions; the liquidation of that excess capacity is sure to produce some capital losses. Enhanced competition will have its normal, and desirable, effect

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of eliminating those institutions that are not competently managed or not efficiently diversified.

Our present structure of 14,000 commercial banks, 5,000 S&Ls, and 20,000 credit unions is hardly optimal. As market segmentation ends, that diffuse institutional structure will coalesce into far fewer entities. The extent of this shakeout should not be underestimated. One very crude and simple approximation can be derived by projecting the banking structure of a state like California, which has operated since 1909 with statewide branching and a low level of market entry barriers, to a national scale. If that is done, the result is a banking system of around 2,000 commercial banks, with over 10,000 of the units lost being the small ones (under $50 million in assets). Even if these rough numbers were doubled, they would still suggest the potential for disappearance of over 70 percent of the institutions now comprising our banking system. While markets would be more competitive, the total number of firms would be much smaller, in national terms.

From a public standpoint, it is critical whether the shrinkage occurs through merger and acquisition or through bank failures. If it occurs by failure, there will be major drains on the resources of the Federal Deposit Insurance Corporation, the Federal Savings and Loan Insurance Corporation, and the National Credit Union Share Insurance Fund—which predictably would lead to political uproar. To lessen that prospect, the banking agencies have recently again proposed legislation to facilitate supervisory mergers or holding company acquisitions across state lines. That proposal may have gone too far politically for the last Congress, where it never came to hearings, but it does not go nearly far enough in economic terms. Mergers and acquisitions, within antitrust standards, should be encouraged—and certainly not barred by phobias about state or industry boundaries—long before the institution becomes a problem case.

As depository institutions experience these pressures in the 1980s, they will probably become much more concerned about activity restrictions that keep them from offering services in which they have some degree of comparative advantage and profit potential. The argument about the harmful consequences of combining banking and commerce in a single company, on which the Nixon administration relied in enacting the Bank Holding Company Amendments of 1970, was always a straw man. During the previous 200 years of our banking history, there was no legal impediment to the combination of banking and commerce under a single parent company. Why then did we not see that dreaded combination of Chase Manhattan with U.S. Steel, or Citibank with DuPont? The answer is much the same as why we do not see McDonald's combining with MGM, or Levi Strauss with General Foods. The combination has no economic advantage but significant diseconomies of management. There are, however, economic advantages in banks or S&Ls expanding into some related lines of financial and consumer services. While the 1970 pressure group tug-of-war in Congress did not lead to incorporation of a "dirty laundry list" of forbidden activities into the law itself, that list seems to have largely guided the Federal Reserve Board ever since its interpretation of the vaporous statutory standard of being "so closely related to banking . . . as to be a proper incident thereto." The result has been to keep banks from offering, and customers from being able to take advantage of, convenient service packages.

Even if it does not make good economic sense to prevent bank customers from reaping the benefits of economies of scope or scale, it may make good political sense for members of Congress to vote that way. The pressures of the 1980s seem likely to heat up a political fight that has been largely dormant since 1970. Whether it will erupt into a major and successful battle, however, is harder to foresee.

IN CONCLUSION, let me stress, not these attempts at prophecy, but a basic principle: The public interest is served by efficient intermediation, not by the preservation of a particular market structure or set of intermediaries. Our present position is the result of a number of waning forces, as well as some misguided legislation; it is not an ideal system to be maintained unsullied by change. It is to be hoped that the sloganeering about housing or level playing fields will not cause us to lose sight of that point. ■

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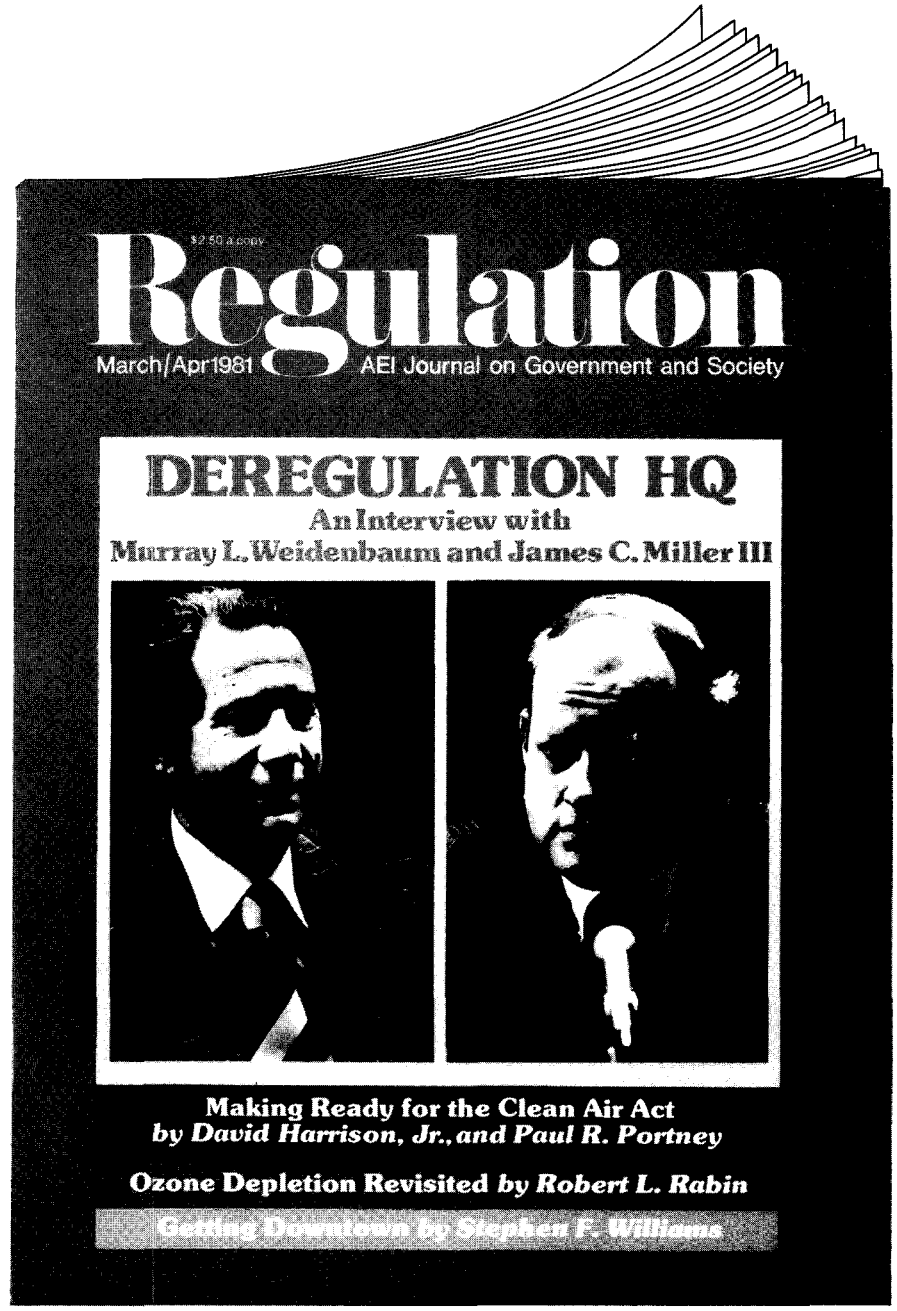
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A Review Essay

Health Manpower and Government Planning

William S. Comanor

LAST SEPTEMBER, the secretary of the Department of Health and Human Services received an imposing volume with an even more imposing name: the *Report of the Graduate Medical Education National Advisory Committee to the Secretary*. GMENAC had been created by HHS's predecessor department in 1976 to examine medical manpower issues, and its report projected the supply of and demand for medical manpower through the year 2000. But the issues raised by the study go beyond those of forecasting. In effect, the study poses the question of how far we should allow central government planning to replace individual choice in medical care.

There were two ways for the committee to approach its task. The more modest approach would have been simply to forecast future supply and demand conditions for medical manpower so as to permit policy makers to consider alternatives in a more informed manner. This would have recognized that final policy judgments necessarily depend on more than mere projections of the future. Unfortunately, the authors of the GMENAC report were more ambitious, and chose the other course. They decided not merely to project market conditions, but also to call for specific policies, concluding —at least implicitly—that policy decisions could proceed from such projections alone.

William S. Comanor, professor of economics at the University of California, Santa Barbara, was formerly director of the Federal Trade Commission's Bureau of Economics.

An Exercise in Government Planning

The authors adopted a characteristic form of government planning. First, they projected future supplies of available resources—in this case, medical manpower—and future levels of demand, represented as "requirements." With those projections in hand, it was a simple matter to detect any impending imbalance between supply and demand, for medical manpower as a whole and for each specialty. They then proceeded to suggest various ways to expand the output of physicians in specialties where they expected shortages and restrict it where they expected surpluses. Since they considered the demand to be "required," they made all the adjustments on the supply side.

When medical resources are allocated according to government plans, prices and financial incentives have no equilibrating function. Prices serve merely to compensate those who provide medical services. Both supply and demand are deemed to be fully determined by technological and demographic factors. Any imbalance can therefore be rectified only by government action.

Even more characteristic of planning documents, the GMENAC report substitutes the preferences of planners for those of consumers. To be sure, it refers to the "required number" of physicians and the health needs of society—but as determined by collective rather than individual decisions. The committee assembled panels of experts for each specialty and subspecialty and asked them to set "desired" levels of medical services specifically "without regard to economic barriers to care." Each accident or illness, the report assumed, requires a specific amount of care that can be determined on a scientific or technical basis and that should be provided, no matter what the cost might be. Any additional care constitutes sheer waste, and should be actively discouraged. The report avoided any attempt to assess the added benefit from a small amount more of a particular service and compare it with the corresponding benefit of various alternatives—for example, professional care versus drugs or medical equip-

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ment. In short, the authors ignored individual preferences for more, less, or different care. They took the view that it is the preferences of medical authorities that count.

Clearly the rationale is that individual patients do not know enough about medicine to decide how much care they require. That individual patients are less informed about the effectiveness of medical care is of course correct. But that is not to say that patients in consultation with their own physicians would not express their own preferences better than an elite group of medical authorities acting alone. Such differences are especially likely since factors beyond the purely technical inevitably intrude into consumer decision making. As Victor Fuchs emphasized in his book *Who Shall Live?* (1974), patients frequently purchase medical services as much for "caring" as for "curing"—and who is to say that the former considerations are not as important as the latter?

Whatever else might be said of planning, it is very difficult to carry out since, among other things, it is not easy to foresee the future. Fifteen years ago, for instance, many believed we faced a doctor shortage, but now the best projections available indicate just the opposite. And there is no indication that the GMENAC planners have mastered the techniques of prophecy any better than the rest of us.

The problem is compounded by the rapid technological change that now characterizes the medical field. To forecast the demand for medical specialties, the GMENAC study necessarily had to forecast the future effects of scientific discovery on medical practice. Some diseases may require more or fewer services as new diagnostic tools and therapies are developed, and new services may be more or less physician-intensive. For example, the discovery of potent tranquilizers substantially decreased the amount of hospital care required for certain patients, while the development of new surgical techniques increased the hospital care required for others.

Given the skepticism that must apply to all such forecasting, it is hardly surprising that the authors of the GMENAC report tempered their policy prescriptions with a moderation not founded on their projections. But in doing so they departed from the implications of their own analysis, and thus inevitably invited the charge that they had been subject to "political influence." What factors, one might ask, determined which of their policy judgments rested on their projections and which did not? Planning models rarely encompass all of the factors that policy makers wish to take into account. But to the extent that the omitted factors become important, the planning process loses its claim to objectivity and becomes ensnarled with the tug and pull of conflicting interests.

The Recommendations

The report projected an "aggregate oversupply" of medical personnel as well as "imbalances" among various medical specialties. It accordingly proposed "to decrease the number of medical graduates, to restrict the entry of foreign medical graduates in the United States, and to change the mix in residency positions." Inconveniently enough, the specialty with the largest projected shortage, general psychiatry, has been heavily dependent on foreign medical graduates in the past. On the other hand, the specialties of general surgery and cardiology have such large projected surpluses that supply and demand cannot be balanced even if all production of these specialists stops for several years.

In fact, the GMENAC panel admitted that to achieve a balance in each specialty as well as overall, the apparent solution "would be to close several U.S. medical schools and expand immigration of FMGs [foreign medical graduates]." But that would be "irresponsible" and "frivolous." So they recommended instead that no specialty increase or decrease its number of trainees by more than 20 percent by 1986. Moreover, they recommended that the number of foreign medical graduates be reduced, shortage or no shortage. These recommendations cast doubt on the overall validity of the model, for if the model is sound, how can its logical implications be irresponsible and frivolous?

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The authors make other recommendations that do not follow from their analysis. Although they project a small surplus in the three pri-

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mary-care fields of general pediatrics, general internal medicine, and family medicine, the report calls for increased manpower in these fields. Primary care is apparently popular in planning circles, and the report duly called for more. Even the American College of Surgeons complained that this recommendation stemmed from "preconceived political considerations."

A major premise of the GMENAC study was that surpluses of medical personnel, unlike surpluses of other goods and services, actually drive costs up. The extra doctors press their superfluous services on their patients, who pass the bills along to third-party reimbursers. And there is no countervailing drop in the salaries or fees of individual doctors, since these salaries and fees do not respond to such marketplace considerations as competition for patients.

Whatever support there may be for this line of analysis, it surely is not enough to justify the anticompetitive prescriptions found in the report. An example of such a prescription is the authors' treatment of nonphysician health providers. In recent years the supply of these providers has been expanded, largely as a means of limiting medical costs. Increasing the use of nurse practitioners, physician assistants, and nurse midwives instead of physicians for certain tasks might well reduce the cost of health care with no loss in quality. But the authors of the report are alarmed at this trend, fearing that it might exacerbate the impending medical surplus. They found that "the numbers of nurse practitioners, physician assistants and midwives will more than double by 1990" and suggested that "the growth rates of these professions be closely monitored in the future. . . ." Although they state this recommendation cautiously, there is a clear implication that something may need to be done—such as limiting the numbers of auxiliary professionals who are trained. Nowhere is there mention of any prospective gains to patients from permitting these professionals to compete with physicians and offer a choice of both services and prices.

What if Not Planning?

The primary issue is not the GMENAC report itself, but rather our commitment to market processes in medical care. Rejecting the report's recommendations does not imply that the current patterns of medical care result directly from the preferences of producers or consumers. Past health policies have affected incentives for all concerned. Favorable tax treatment of health insurance has stimulated the demand for medical care, and thus increased private returns on investment in medical education. At the same time, subsidies have also considerably reduced the cost of medical education, subsidizing those fortunate enough to study medicine in the United States. On both counts, existing policies towards medical education are hardly neutral.

Here, as elsewhere, we cannot achieve policy neutrality merely by standing pat. Because of the government regulations already in place, new measures would be needed simply to achieve neutrality. And some of the policy recommendations contained in the report would indeed move towards neutrality. For example, the report recommends that the Health Professions Educational Assistance Act of 1976 be amended so that a medical school is no longer required to maintain or increase enrollments as a condition of receiving certain funds.

Adopting the goal of neutrality would lead to maximum reliance on individual choice. A fundamental element of free choice is the right of all persons to enter the occupation of their choice so long as they are willing to bear the costs. (These costs involve not only training, but also the reduced earnings that might result from choosing one occupation rather than another.) Several of the report's conclusions would limit this right. They include not only the recommendation that the number of foreign medical graduates permitted to practice in the United States be severely restricted, regardless of their skills and specialties and regardless of whether they are U.S. citizens, but also the recommendation that first-year U.S. medical classes be limited to current levels and that no new medical schools be established here, regardless of the demand for medical education. Again and again the report chooses the course of greater reliance on collective than on individual decision making.

There is a final recommendation worth noting—that the activities of the Graduate Medical Education National Advisory Committee be continued for another year. In view of the committee's efforts to date, that recommendation is one I could not support. ■

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Readings
of particular interest

Hospital Duplication and Cost Control

"Duplicated Hospital Facilities: How Much Can We Save by Consolidating Them?" by William B. Schwartz and Paul L. Joskow in *The New England Journal of Medicine*, vol. 303 (December 18, 1980), pp. 1449-1457.

A major goal of health planners has been to prevent unnecessary duplication of health facilities. In 1978, the Health Resources Administration (HRA) of the Department of Health and Human Services established guidelines for regulators to use in avoiding such duplication. To date, however, there has been no systematic analysis of the savings that would accrue if the guidelines were fully implemented.

In this study, William Schwartz, professor of medicine at Tufts, and Paul Joskow, professor of economics at the Massachusetts Institute of Technology, evaluate the potential cost savings from the consolidation of the four kinds of facilities most often viewed as costly and redundant: computerized axial-tomographic (CAT) head and body scanners, open heart surgery and cardiac catheterization facilities, megavoltage radiation therapy units, and general hospital beds. They conclude that "the expected saving falls far short of HHS goals," and that the costs of consolidation—in regulatory expense and inconvenience to patients—"would reduce or possibly eradicate this gain."

The authors first determine the number, intensity of use, and annual operating costs of the facilities in each category. Taking total patient demand as fixed, they then compare the actual rates of usage with the HRA guidelines and calculate the number of facilities required to serve prevailing patient demands at the utilization rates defined by the guidelines. The difference between the actual number of facilities and the "required" number indicates the extent of duplication. Finally, they multiply the number of patients served in duplicative facilities by the average current cost per patient, and subtract the marginal cost of treating these patients in remaining facilities. The result is the net savings from consolidation.

For CAT scanners, Schwartz and Joskow found that more than 70 percent of head scanners met HRA's optimal utilization criterion of fifty procedures a week. The other 30 percent served an average of thirty-seven patients a week. Body scanners, which constitute two-thirds of all CAT scanners, had a lower rate of usage, almost 80 percent failing to meet the guidelines. The authors conclude that $85 million would be saved by meeting the guidelines, mostly from the consolidation of body scanners.

To estimate the savings from consolidating open heart surgery facilities, the authors first develop estimates of the fixed costs of an open heart surgery operating at low volumes in a well-equipped community hospital. Extrapolating from California data on actual utilization levels, Schwartz and Joskow estimate that about $15 million a year would be saved nationwide from consolidation, less than 2 percent of the total cost of hospitalization for open heart surgery. The saving could, however, be as low as $10 million or as high as $30 million a year. Using similar procedures, the authors estimate a theoretical saving of $15 million a year for cardiac catheterization.

For therapeutic radiology, the authors estimate that in 1977, 70 percent of patients were treated in facilities meeting the HRA guidelines of at least 300 procedures a year. Lacking good information on how unit costs decline as the number of cases increases, the authors assumed that radiation units had scale economies similar to those of CAT scanners. This and other assumptions, together with estimates of the distribution of utilization and the average cost per procedure, resulted in an estimate of $115 million in annual savings.

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Among the most visible targets of consolidation have been hospital beds. According to some estimates, 5 to 10 percent of the beds in short-term general hospitals (60,000 to 100,000 beds) are unnecessary. Yet definitions of and data on excess hospital beds have been imprecise. For example, the HRA guidelines, in defining "excess," do not distinguish among beds that are never used, misused beds (those occupied by patients who could be cared for as outpatients), and underused beds (those uneconomically reserved for peak demand periods). Moreover, studies of bed use have presented average rates of use for entire hospitals rather than for separate departments such as surgical and medical. In addition, studies tend to neglect the fluctuation of patient demand. But even with precise definitions and more informative data, the authors point out, the judgment on appropriate bed capacity will vary from physician to physician. There is inevitably legitimate disagreement concerning how long a hospital stay should last and when outpatient should be preferred to inpatient care.

Schwartz and Joskow estimate that 75,000 beds, or 7 percent of all hospital beds, could be eliminated without significant increases in admission delays. At an average cost of $52,000 per year per bed at a community hospital and assuming the marginal cost of care to be 80 percent of the average cost, that would reduce total hospital expenditures by $800 million a year, or about 1.4 percent.

All in all, the authors conclude that less than 2 percent of total hospital expenditures, or $1 billion, could theoretically be saved if HRA's guidelines were observed in the four areas. Under different assumptions, the figure could range from $650 million to $2 billion.

Schwartz and Joskow then discuss the offsetting costs of consolidation, including the administrative costs of the regulatory process and the costs to patients and families of less convenient locations. In 1978 the federal government gave $160 million to local, regional, and state agencies for health planning. The authors estimate that state expenditures are at least half those of the federal government, bringing the total cost of administration to $250 million. Since under the planning process providers must file applications to construct or expand facilities and must collect data to support their applications, they wind up spending "at least as much as the agencies do . . . and probably more."

For patients and families, increased travel time imposes additional costs, as well as physical risks to patients requiring immediate attention. Moreover, delays in treatment may themselves make treatment more expensive. These costs are not estimated since they vary according to patient preferences and the specific ways the regulations are put into effect.

Schwartz and Joskow conclude that after offsetting costs are considered, even the most promising consolidations yield "disappointingly small" results. Significant cost containment is more likely to come from systemic changes in the delivery of medical care: more outpatient care, shorter stays, more intensive use of hospital facilities during off-peak periods, and other improvements in hospital management. Only by changing "the quantity, quality, or patterns of care . . . and by providing general incentives for hospitals to eliminate organizational slack" can cost containment be an ongoing rather than a one-shot attack on escalating medical costs.

Natural Gas Deregulation: The Costs of Gradualism

"The Regulation and Deregulation of Natural Gas in the U.S., 1938-1985" by Peter R. Merrill, in the Harvard Energy and Environmental Policy Center Discussion Paper Series (January 1981), 94 pp.

In September 1978, eighteen months after the Carter administration announced its National Energy Plan, Congress passed the Natural Gas Policy Act. As in the case of the airlines, this deregulatory legislation provided neither complete nor immediate decontrol. And according to Peter R. Merrill, a researcher at Harvard's Energy and Environmental Policy Center, it constitutes a Pyrrhic victory for supporters of natural gas deregulation because it mandates a "deregulatory lag" whose consequences will be worse than those of the controls the law supplanted.

Federal Energy Regulatory Commission controls will actually tighten in several areas during the seven-year transitional period from

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1978 to 1985, according to Merrill. The act extends federal rate regulation to the intrastate market and, for the first time, authorizes FERC to set gas rates for some industrial customers. Moreover, Merrill says, what price relief the act does grant to producers is likely to prove inadequate. During the transitional period, for example, the act limits the increase in the ceiling price of natural gas to 4 percent above the inflation rate. Soon after the act was passed, however, the import price of natural gas increased 48 percent in one year as a result of the Iranian revolution. The act allowed the ceiling price to rise by only 11.6 percent in the same year. Before "deregulation," FERC had adjusted the interstate price every two years to reflect the price of gas imports.

Merrill concludes that the gap between domestic and world prices would have been closed more quickly under previous FERC policies than it will be under the act. Now, pipelines will pay far more for foreign sources of natural gas than domestic producers are permitted to charge, encouraging imports at the expense of domestic production. Moreover, the act may backfire completely if the price gap becomes so large that decontrol becomes politically infeasible in 1985.

Deregulation was sidetracked, Merrill says, by the politics of regional economic interest. Before President Carter submitted his National Energy Plan, the Senate had voted three times for field price decontrol, while the House, where consumer states have greater representation than producer states, had consistently opposed it. The complex deregulation measure, which emerged in conference from radically different House and Senate bills, attempted to reconcile two conflicting goals: lifting field price controls and sparing residential and small commercial customers from sharp price increases. It sought to stem the flight of natural gas from interstate to intrastate markets, not by quickly lifting the interstate price controls that caused the shortage, but by extending them to the intrastate market. The incremental pricing provisions of the act also require pipelines to recover their higher acquisition cost of natural gas first from large industrial customers, up to the price of alternative fuel, and only then from residential and commercial customers.

The unregulated market is an ideal allocator of natural gas, the author writes, supplying gas to those end-users who value it most highly. But while protracted phase-in periods and interim extensions of regulatory jurisdiction may be a political requisite of decontrol legislation, the "curtailment" provisions of the act are both economically unwise and politically unnecessary. Here, Merrill says, a "second-best" policy would have achieved a more efficient allocation of natural gas without harming residential and commercial customers. When utilities curtail supplies under the act, they must allocate gas according to purchases made in 1972, without regard to changing demand conditions or regional variations in the permissibility of burning high-sulfur fuels. At least among industrial customers, a price system could replace arbitrary curtailments. The "Vickrey" auction, a sealed-bid auction used for new equity issues on the French stock exchange and certain Treasury bill sales here, is one such simple and efficient procedure. Merrill estimates that $1 billion was lost to the U.S. economy in 1977–78 because of inefficient curtailment practices. Half of this loss, he concludes, could have been eliminated by competitive auctions.

Stalking the "Unfair" Price Cut

"Predatory Pricing Revisited" by John S. McGee, in *Journal of Law and Economics*, vol. 23 (October 1980), pp. 289-330.

Can a firm that is dominant in an industry cut its prices enough to drive its competitors out of the field, and then raise prices to monopoly levels? This question has long engaged the attention of economists and antitrust theorists. In this article, John S. McGee of the University of Washington critically reviews the recent literature on "strategic" or "predatory" pricing. His own view is that because "predatory price cutting imposes greater costs upon predator than prey," it is unlikely to pose much of a threat to competitive balance.

A "strategic" price cut is one that would not have been undertaken except as an investment in greater future monopoly. But since price cutting is normal competitive behavior in a great many situations, especially where one firm is more efficient than another, strategic

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price cuts are frequently hard to distinguish from "nonstrategic" or ordinary cuts.

A dominant firm will succeed in its predatory campaign only if the competitor it is attacking permanently retires its assets from production—converting them irrevocably to other uses, selling them to the predator, or simply not replacing them as they wear out. A predatory strategy of "grinding down" a victim's plant, so that it wears out faster than it is replaced, may pose more risks for the would-be monopolist than for the victim. Since the predator is likely to increase its market share and thus its share of production, McGee notes, it will be grinding down its own plant faster than its competitor's. (If the predator is pricing below its variable costs, it will also be losing more money than its victim both absolutely and proportionately.) And "because it will take a long time to grind down long-lived and specialized capital assets," McGee says, "these kinds of assets hold the predator hostage at least as effectively as they do the prey."

Moreover, a victim's decision to withdraw its assets permanently from the field depends not on the current but on the expected future profitability of the assets. Even if the victim is now losing money, the prospect of earning high profits when the price war is over will encourage it to replace its assets as they wear out and to demand a high (rather than distress) price if the predator offers to purchase. The predator could, to be sure, wipe out the victim's expectation of future profits if it could effectively threaten to hold prices down indefinitely. McGee contends, however, that such a threat is unlikely to be believed, since it would be suicidal to carry it out unless the predator were genuinely more efficient than the prey. Some theorists have speculated that a predator with a "long purse" could outlast a victim in a price war. McGee counters that no one has ever shown why predators could acquire the reserves they need, but victims could not. Attempts at predation may also be foiled if customers can store commodities during periods of low prices or enter into contracts with the predator's intended victim. Nor will actual or threatened predation be any more successful, he says, as a way of discouraging prospective or potential competitors.

McGee discusses a variety of standards proposed by lawyers and economists to guide courts in weighing allegations of predatory pricing. Some legal rules would require price reductions to be "quasi-permanent," restrict promotional pricing, or forbid dominant firms from increasing output in the face of new competition. Too many of these proposals, he says, would encourage charges of predation by less efficient firms that have (quite properly) been forced to the wall as a result of ordinary competitive price-cutting.

Merit, Bias, and Professional Work

Reasoning about Discrimination: The Analysis of Professional and Executive Work in Federal Anti-bias Programs by Richard A. Lester (Princeton, N.J.: Princeton University Press, 1980), 384 pp.

Federal affirmative action efforts typically follow a two-stage pattern. In the first stage, the government tries to prove past discrimination by comparing the racial or sexual composition of an employer's work force with that of some relevant pool of job applicants or the labor force in general. If the government claims to find such past discrimination, it proceeds to the second stage: negotiating an affirmative action plan by which the employer agrees to adopt numerical hiring and promotion goals for members of the protected groups.

In this book Richard Lester, formerly dean of faculty at Princeton and vice-chairman of the President's Commission on the Status of Women, critically examines the federal contract compliance program, the Equal Pay Act, and the Age Discrimination in Employment Act as they have been applied to professional, academic, executive, and civil service employment during the past decade. He argues that the methods used both for assessing discrimination and for remedying it where found are ill-suited to many types of professional and managerial work and tend to undermine the integrity of promotion and pay systems based on individual merit. The primary reason for this, he says, is that the performance of "highly individualistic" scholarly or managerial work cannot be easily standardized and quantified for purposes of comparison across broad categories. Most analyses of discrimination fail because they must ignore individual performance

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and concentrate instead on a few easily measured aggregates.

In university faculty hiring, according to Lester, the government attempts to prove sex bias by referring to the overall male/female ratio in the Ph.D. population, omitting from consideration the individual performance factors—for example, quality of research—that actually lead a department to choose one Ph.D. over another. An added problem is "that it makes no allowance for the effects of women's career choices," such as temporary withdrawal from the labor force or voluntarily adopted geographical restrictions. In managerial employment, similarly, the government does not allow for the effect of "protective" state laws which until the late 1960s kept many women from gaining experience in professions requiring long hours and night work.

Since the proportion of women among new Ph.D.s increased from 10 to 12 percent in the 1950s and 1960s to 25 to 27 percent in the late 1970s, he says, sex ratios for faculty hired and promoted in the earlier period naturally lag behind the current ratio for all Ph.D.s.

> A university that in 1970 was judged to have no underutilization of women in its academic departments (and, therefore, was then not required to have any numerical hiring and promotion goals for its faculty) would be apt by 1977 to be charged with significant underutilization of women in many departments, even if it had exactly the same faculty in 1977 as in 1970 with no losses or new hirings during those seven years.

When the government came up with guidelines for the analysis of university salaries, it provided that "only the salaries of women and minorities were to be tested for salary equity, and only those below the calculated norm were to be considered for corrective, special salary increases." Correction, Lester notes, "is not for all inequity but only for persons in the designated categories and in one direction." Labor Department lawyers, Lester adds, have sought to prove invidious pay disparities by pairing "a single female and a single male faculty member across disciplinary lines in the arts and sciences (for example, a professor in English and one in chemistry)," because both are in the same occupational category in the same "establishment." They do this even though the college may be competing with lucrative outside pay offers in the latter but not the former case.

Lester is also critical of the Age Discrimination Act Amendments of 1978, which when fully implemented will forbid the involuntary retirement of tenured professors below age 70, and of similar laws in California and Connecticut forbidding involuntary retirement at any age. These laws, Lester says, are helping to perpetuate the disparities of which the government complains.

Inspecting Great Britain

Inspectorates in British Government by Gerald Rhodes (Winchester, Mass.: Allen & Unwin, 1981), 281 pp.

"The Statute Book from the time of Henry the Third," a British Parliamentary committee once noted, "abounds with Acts of Parliament enacting and declaring that there should be one uniform Weight and Measure throughout the Realm; and every Act complains that the preceding Statutes had been ineffectual, and that the Laws were disobeyed." In 1835, accordingly, Parliament set up a corps of local inspectors empowered to enter shops to enforce the Crown's edict.

The weights and measures inspectors were among the first of what have come to be tens of thousands of central government officials authorized to enter private premises across the land to check on everything from the marketing of British eggs to the working conditions of British skin divers. In this volume, Gerald Rhodes of the Royal Institute of Public Administration discusses the proliferation of the "inspectorates," as they are called, and their current role in enforcing regulations.

The first British inspector was Her Majesty's Inspector of Anatomy, appointed in 1832 to scrutinize the conditions under which cadavers were used to teach anatomy to medical students. By the end of the 1870s, there were more than a dozen different health and safety inspectorates, some with wide-ranging powers. Environmental inspectors could declare a furnace a nuisance unless it reduced its smoke emissions "as far as practicable," and could require water polluters to use the "best prac-

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ticable and reasonably available means" of rendering their effluents harmless.

Although the task of most inspectorates is to enforce laws and regulations, a few supervise the activities of local schools, police, and fire departments. These so-called efficiency inspectorates work through administrative (rather than judicial) processes, and their inspection powers are generally less explicit than those of the enforcement inspectorates. Their most powerful weapon in holding local authorities to defined standards of performance is frequently their power to recommend that the central government withhold grants.

The efficiency inspectorates are nearly as old as their enforcement counterparts. Their power to inspect local schools, for example, dates back to 1839, when Parliament made inspection a condition for central government financial grants to local schools. But in recent decades, efficiency inspectorates have languished. Some, such as Poor Law inspectors, have disappeared, while others, such as prison inspectors, have been internalized by the regulated body. The education inspectorate, by far the largest efficiency inspectorate remaining, has been criticized by both teacher and administrator groups, both of which would like it reduced to a purely advisory function.

Enforcement inspectorates, by contrast, have grown steadily both in number and in breadth of responsibility. The weights and measures inspectors now enforce a broad range of "consumer protection" laws—processing complaints, interpreting the law to merchants, and running consumer advice centers. Although they have doubled in number since 1950, they have cut back severely on inspections because of these new responsibilities. Similarly, in the case of the electrical safety inspectors, Rhodes says that "perhaps their major function is the conduct of public inquiries and hearings, following objections to proposals by electricity boards for new power stations or overhead lines."

According to Rhodes, the inspectorates' usual "reliance on cooperation and persuasion rather than strict enforcement" accords with "British empirical tradition." However, since it is the inspector who effectively decides whether to prosecute, the inspector's suggestions can easily be received as if they had the force of law. For, as one study of factory inspection put it in 1970, "it is extremely rare for a general inspection *not* to result in a 'discovery' and formal notification of a number of breaches of the law for which criminal proceedings could be instituted."

Washington and the Schoolhouse

"The Government in the Classroom" by J. Myron Atkin, in *Daedalus*, vol. 109 (Summer 1980), pp. 85-97.

Public schools have "become an arena for some of the country's major struggles for political power," writes J. Myron Atkin, dean of Stanford's School of Education. Atkin surveys the growth of federal regulation of local schools and suggests that the quality of education may be suffering "as power shifts from teacher to politician and civil servant."

Washington's role in elementary and secondary education dates back to the late fifties, when concern over the Soviet Sputnik launch and memories of the Manhattan Project in World War II spurred a major push for improved science education. When Congress passed the National Defense Education Act in 1958, few observers feared any eventual loss of local autonomy. The importance attached to national defense and the nearly unanimous public support for science as a good easily overcame what few objections there were.

Questions of race and poverty provided the basis for the next great leap in federal involvement, the Elementary and Secondary Education Act of 1965. Title I of that act established a "compensatory education" effort, including curriculum development, to improve schooling in the poorest urban areas.

The 1958 and 1965 acts, by plunging the government into the details of school curriculum, helped open the way for much more extensive federal intrusion in the next decade. "[T]he curriculum activities — because they were uncontroversial in the early years and seemed so reasonable—helped to create a climate in which government intrusiveness seemed natural."

It was in the 1970s that special-interest groups began working their will systematically on local education, Atkin says, with help from

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both legislatures and courts. Schools were increasingly under obligation to provide for bilingual education, ethnic history, vocational education, and drug abuse counseling, among many other programs. The passage of such landmark legislation as the Education of All Handicapped Children Act of 1975, which required educators to come up with an individual learning plan for each child, was testimony to the political clout of the interest groups.

The first major reaction to federal involvement arose in the mid-seventies, with the controversy that surrounded "Man—A Course of Study" (MACOS), a curriculum project supported by the National Science Foundation. While parent activists could block some individual projects of this sort, they soon discovered that local schools had come to rely on federal financial help. "The 8 or 9 percent of the local education budget provided by the federal government," notes Atkin, "turned out to be not marginal but essential."

State governments too were extending unprecedented controls over local educational autonomy during the seventies. Here the reasons were different: a desire to cut costs during a period of falling enrollments and a pervasive concern about the decline in educational quality indicated by the continuing drop in test scores. State governments also were susceptible to special-interest lobbying. One ballot initiative now pending in California would require 200 minutes per week of instruction in the arts.

Some interventions crop up in different forms at the state and federal levels. One is the continuing policy of "mainstreaming" children who once were placed in special classes or institutions, such as the handicapped or delinquent, who are the subject of federal and state guidelines respectively. Because such children command disproportionate attention from the teacher, they can disrupt regular educational activities.

Caught between state and federal, legislative and judicial, presences in the classroom, teachers are increasingly finding that their "range for professional action is being narrowed, with individuals farther and farther from the classroom making basic decisions about curriculum," Atkin says. And while the government intrusions may have helped some of the most disadvantaged students, Atkin believes, the overall effect has been more a leveling down of achievement. He predicts that parents with the means to do so may provide their children with private educations in coming years, adding: "We may be entering a period in which government services reduced to the bone will increasingly serve only the handicapped, the juvenile offender, and the poor."

Deregulating Concentrated Markets

"Deregulation and Oligopolistic Price-Quality Rivalry," by James H. Vander Weide and Julie H. Zalkind, in *American Economic Review*, vol. 71, no. 1 (March 1981).

Many discussions of the likely economic effects of deregulation are implicitly based on the classical model of perfect competition. According to James H. Vander Weide of the Duke University Graduate School of Business Administration and Julie H. Zalkind of the Energy Information Administration, however, such industries as airlines, banking, and trucking—all favorite targets of deregulators—do not obey the standard laws of perfect competition. Instead, they are more usefully thought of as oligopolies in which each competitor is large enough to have a significant effect on the decisions of others.

In this article, Vander Weide and Zalkind examine the economic consequences of deregulation using a model of regulated oligopolistic rivalry. The oligopolistic firm in their model produces a product having both quantity and quality dimensions. Although the firm's revenue is explicitly based only on the quantity it sells, the demand for its product depends on the product's price and quality, as well as those of its competitors.

Vander Weide and Zalkind study two possible types of cost function, representing contrasting ways in which quality can affect the costs of production. One applies to those dimensions of quality, such as automobile safety, whose cost varies directly with sales volume. The other applies to quality dimensions, such as numbers of bank branches or airline flights, whose cost is independent of sales volume (adding a new flight may cost about the same amount whether it attracts one or fifty new customers). Both of the authors' cost functions

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allow for the presence of economies or diseconomies of scale.

For each cost function, Vander Weide and Zalkind examine the economic effects of deregulation in two kinds of industries—those where price and entry are regulated and firms compete on the basis of product quality, such as airlines and trucking, and those where quality and entry are regulated but firms compete on the basis of price, such as banking in states that limit branching. Their results suggest that the economic consequences of deregulation depend on a variety of factors, including which variables had previously been regulated and which are to be deregulated, whether the regulated variables had been fixed at levels higher or lower than those which would obtain in an unregulated oligopoly, and the nature of individual firm cost and demand functions. If entry into airline markets is deregulated but price remains fixed, for instance, then the number of flights per carrier, the number of passengers per carrier, and the load factor will decrease, but total flights serving the market and total passengers in the market will increase. If both price and entry are deregulated, however, the increase in flights in a market resulting from entry deregulation may be more than offset by a decrease in flights resulting from price deregulation. This effect could occur where the pre-existing regulated price level was below that which the unregulated oligopoly produces.

The Profits in Recycling

"Making Pollution Prevention Pay" by Michael G. Royston, in *Harvard Business Review*, vol. 58 (November/December 1980), pp. 6-22.

Alert firms can often make pollution control profitable by recovering valuable resources formerly lost in the form of effluents. Michael Royston, professor of technology and environment at the Center for Education in International Management in Geneva, Switzerland, collects in this article information on scores of profitable ventures in resource recovery around the world.

A metallurgical process developed in Finland, for example, turns 98 percent of the damaging sulfur dioxide fumes from copper smelting into salable sulfuric acid. A $2.7 million initial investment enables Dow Corning to recover chlorine and hydrogen formerly lost to the atmosphere in making silicon, at a $900,000 annual savings in operating costs. Georgia-Pacific's paper mill at Bellingham, Washington, is producing as a byproduct alcohol so potent (190 proof) that "the Treasury Department has stationed men in the plant full-time to make sure that none of it is converted to drinking liquor before its sale to industrial users."

Energy and animal feed are two frequent products of waste recovery efforts. Steam and hot gases from coke ovens, methane from organic wastes, and bark and sawdust from for-

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est industry waste are potential heat sources; livestock thrive on wastes from distillery, cheese, and citrus processing operations, and even on wastepaper. Cement, fertilizer, and building materials are other common recovery products. One British firm uses its china clay wastes to make prefabricated houses.

Often waste recovery is institutionalized by operating the waste-producing and waste-consuming processes at the same site. This "systems approach" is particularly suited to thermal effluents, which are used for everything from local space heating to the cultivation of eels ($6 million worth at one Scottish distillery). Royston lists twenty-five examples of such integrated systems.

Royston cites Minnesota Mining and Manufacturing (3M), the diversified American company, to demonstrate how one firm can profit by "viewing pollution as an indicator of waste and an opportunity for profit rather than as a costly threat." In a four-year span in which 3M's production increased significantly, the company cut its liquid effluents from 47 tons to 2.6 tons, gaseous effluents from 3,000 tons to 2,400 tons, and solid waste from 6,000 tons to 1,800 tons. The result: a saving of $2.4 million a year. Perhaps most significant is that 3M achieved its gains not by installing new pollution control equipment but by rethinking the production process itself: "reformulating products, redesigning equipment, modifying processes, or recovering materials for reuse." Royston sums up this approach as "good housekeeping." "The key to 3M's success," he adds, "has been giving corporate-wide recognition to the importance of technological innovation in making the company efficient and profitable, delegating responsibility and initiative to the shop floor, and rewarding all company personnel who get involved" in the program.

But even 3M would be hard put to match DSM, the Dutch state coal and chemical enterprise. DSM stages internal simulations of public environmental-impact hearings, with company employees playing the roles of ecology activists. Such precautions can help avert court challenges to planned projects, Royston says, adding: "The ultimate objective of the corporation is survival, and reaching that depends very much on the adaptation of the corporation to its environment."

Making Cable TV Pay?
(Continued from page 39)

approach would eliminate the cumbersome and impractical CRT process, leaving the pricing of copyrighted programs to the marketplace.

Admittedly, this solution is imperfect. However, in light of the entrenched position of the traditional cable system and the claims of their viewers, some compromise with free market principles is probably unavoidable. The compromise outlined here is the fairest possible, for both cable and for the copyright owners. The latter would have full copyright protection in those markets (the 100 largest) from which they draw 90 percent of their revenues. And the great majority of the 4,200-odd cable systems would be better off because, as systems in the smaller markets, they would have no copyright payments. The larger cable systems in the top 100 markets can well afford to pay for the programming they use and, in any event, will depend for their success on pay-TV and the new services. For them to seek to retain the relatively small advantage of a compulsory copyright for distant signal carriage is piggishness—an assault on the rules of fair play.

IT IS DIFFICULT to sympathize with the broadcast industry. Indeed, there is something almost deliciously ironic in the problems it now confronts because of cable. For it was VHF broadcaster pressures that led to the present inadequate spectrum allocations system that, in turn, fostered the growth of cable (see Stanley M. Besen and Thomas G. Krattenmaker, page 27). And it was the broadcasters that held back the development of over-the-air pay-TV for decades, so that when enterprising cable systems turned to satellite-distributed pay-TV as a device for penetrating the major markets, the move was not precluded by a long-established subscription TV service. Like Rubashov in *Darkness at Noon*, they are being devoured by a force of their own making (although it should be noted that about one-third of the cable systems are owned by VHF broadcasters).

The copyright owners, however, have done nothing to deserve the inequities of compulsory license. Enough violence has been done to the marketplace in the last two decades. It is time—indeed, long past time—to bring true deregulation to the cable copyright field. ■

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(Continued from page 3)

Electric Utility Regulation

TO THE EDITOR:

In his "Electric Utility Regulation and National Energy Policy" (*Regulation*, January/February), Peter Navarro points out that, because state public utility commissions (PUCs) have granted electric utilities inadequate rate relief, many electric utilities have failed to convert their power plants to non-petroleum fuels and have continued to burn oil, much of which is imported from OPEC. Furthermore, he warns that, unless state commissions allow electric utility rates to rise, federal intervention to protect the national interest is warranted. The article seems to support past Department of Energy policies (excluding oil price control) by asserting that any action designed to reduce oil imports is ipso facto in the national interest. Unfortunately, if we were to adhere to such a criterion and judge energy policies essentially by the number of barrels of imported oil they save, serious distortions would arise.

The article places too much blame on the state commissions for the country's continuing dependence on foreign oil and too little on the federal government, particularly its price control policies, which Navarro admits have been the "primary villain." The article's view of state regulators is similar to that of the Public Utility Regulatory Policies Act (PURPA), which has required state commissions to implement or at least consider five ratemaking and six regulatory standards. The act has partly displaced the discretion of state commissions to place a priority on ratemaking issues.

State commissions are concerned that electric utilities are not earning a fair rate of return. And most of them are studying the likely effects of the changes Navarro recommends—allowing utilities to include construction work-in-progress (CWIP) in the rate base, to use a future test year, to "normalize" deferred taxes and investment tax credits, and to reduce regulatory lag. State commissions are now in a transitional period, evaluating the adequacy of their past policies in today's inflationary environment....

But I do not agree that granting more rate relief is necessarily in the long-run best interest of consumers. For example, if we allow utilities to use a future test year, they may, under plausible situations, inflate their costs in order to meet their earlier projections and consequently make their future projections more credible. Allowing CWIP in the rate base may not be in the best interest of consumers except under specific circumstances....

Three factors explain the delay, and in some cases the cancellation, of new power plants construction: the slowdown in the expected growth of electricity usage, environmental standards, and financial problems. The first two have probably been more important than the third; certainly the Nuclear Regulatory Commission has been the number one hindrance to the completion of nuclear plants. The author would have been more convincing if he had offered statistics showing that delays in plant construction are longer or more frequent in states where the regulatory climate is "unfavorable." Instead he merely infers, without empirical evidence, that many delays are caused by the worsening of the utilities' financial condition.

It is true that many state commissions have not allowed electric utilities to earn a fair rate of return. That is a problem that only the state regulators themselves can solve. Federal intervention would only muddle the process. The most effective way the federal government can reduce our dependence on foreign oil is to streamline nuclear licensing and to avoid interfering with the operation of the marketplace.

Kenneth W. Costello,
Staff Economist,
Illinois Commerce Commission

TO THE EDITOR:

Peter Navarro's article is built on four unarguable propositions: (1) the current financial condition of much of the electric utility industry suggests that investors perceive significantly increased risk; (2) the policies of utility regulatory commissions will be reflected in the interest utilities will have to pay on new borrowings and the price they can command for their stock; (3) if companies can borrow only on unfavorable terms, or not at all, and if they cannot issue more equity without diluting the value of existing shares (because the market price is well below the book value), they are not likely to build the plants that could help cut the nation's oil consumption; and (4) it is highly unlikely that the industry can be quickly restored to the financial strength it had in the 1950s and 1960s.

This last proposition led me some time ago to Navarro's view that federally financed conversion of oil-fired power plants to coal is needed to achieve the pressing national objective of reducing oil consumption. And the "bailout" objection that Navarro cites as a major obstacle can be overcome. Since the Department of Energy has itself judged that the operating savings from conversions will in fact exceed their capital cost, all that is required is that the government undertake to guarantee that judgment.

More specifically, the federal government would advance to utilities the capital necessary to carry out the coal conversions it deemed desirable. State regulatory commissions would be required to fix utility rates *after* the conversion as if oil were still being burned, and the difference between the revenue produced by these rates and the revenue the utility needed to cover its *actual cost* of operation—now presumably lower because coal is cheaper than oil—would enable the utility to repay the federal government for its advance. When the advance was repaid in full, rates would be adjusted to cover actual fuel costs....

Consumers could be no worse off under this scheme than if coal conversion had never been attempted. If a conversion, subject to federal oversight, did not produce operating cost savings sufficient to cover all of its capital cost—because, for example, a change in federal environmental, safety, or transportation regulations resulted in dramatic increases in the cost of producing electricity with coal, or even precluded the use of coal at certain locations—consumers simply would not repay the full federal advance. But only in this presumably unlikely case would the advance become a partial grant.

A good long-run answer to the problem of fostering proper electric utility investments is not so clear. Perhaps Navarro's regulatory reform proposals (which are not new) are the solution. But his implicit thesis is that the variables he has identified determine decisions on the issues presented by the "six objective financial criteria" that make up a "regulatory environment." That suggests that the issues themselves are substantively uncontroversial. This would come as a great surprise to the many professional economists, accountants,

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financial analysts, and lawyers who have been arguing about inter-generational equity, due process, efficiency incentives, and other concerns they see in these issues.

If Navarro had demonstrated that these concerns are unwarranted or unimportant, or that they must be sacrificed in order to achieve the proper level of investment, his proposed long-run solution would be more persuasive.

Charles A. Zielinski,
New York Public
Service Commission

TO THE EDITOR:

Contrary to what most consumer groups believe, Wall Street does not assess the regulatory environment of a utility solely on the equity return it is granted. As a former member of the Texas Public Utility commission and one of its three original appointees in 1975, I discussed the Texas regulatory environment with Wall Street groups on several occasions. An officer of Standard and Poor explained to me that his group was as wary of too-generous rate decisions as they were of inadequate ones. Either extreme resulted in uncertainty — Wall Street's greatest dread.

I agree with Navarro that decisions aimed at pleasing consumers often give them only a fleeting advantage, while leading to low bond ratings for the company. Adequate rate relief in the long run brings about lower financing costs and, eventually, more stable costs, even though it means higher rates in the interim.

Alan R. Erwin,
Dow Chemical

TO THE EDITOR:

. . . There is a technical flaw in Peter Navarro's analysis that warrants a comment. Navarro states, "One measure of the cost of equity capital is the utility's M/B ratio, the ratio of the market price of a utility's common stock to its book value" and "[i]n general, the lower the M/B ratio, the higher the cost of equity capital." He then goes on to cite some evidence that relates quality of regulatory climate to M/B ratio and infers that as the quality deteriorates, the cost of equity goes up.

This line of reasoning is faulty. The market-to-book ratio essentially reflects the market's anticipated rate of return relative to its required rate of return and will be equal to one if the two coincide. The latter is the "cost" of equity capital and is determined by investors' risk perceptions and their time value of money. It may differ significantly from one utility to another. Now since the principal determinant of regulatory climate Navarro cites is the rate of return allowed by the PUC in recent cases, which is presumably a proxy for anticipated future allowed rates of return, it is not surprising that Trout and Navarro both found that the M/B ratio correlated with the regulatory climate index. But nothing about the absolute value of the cost of equity capital can be concluded from this correlation. If the market requires a higher rate of return from one utility than from another, the former will have a higher cost of capital than the latter. This is so even if the former is allowed by its PUC to capture a higher share of its required return than the latter—and thus attains a higher M/B ratio. Thus the M/B ratio is *not* a measure of the cost of equity capital.

In spite of this minor misconception, the essence of Navarro's argument is still valid. There is a negative relation between the cost of equity capital and the quality of regulation, but the causal mechanism is via risk reduction. An investor who believes a state commission to have the intellectual capacity to recognize that politically palatable short-run decisions may have very costly long-run consequences, and believes the commission to have the integrity to make the unpopular decision, will expect a more stable income stream. Such an investor will require a lower risk premium, and thus the cost to the utility of equity capital will be lower than it would otherwise be.

Jerome E. Hass,
Cornell University

PETER NAVARRO responds:

I can hardly disagree with Erwin, who constructively clarifies issues on which we totally agree. Nor do I find much fault with Zielinski's eloquent defense of federal aid for oil displacement. I do, however, wish to disavow any "implicit thesis" that regulatory policies have no implications for equity, efficiency, and law.

Hass's argument that the M/B ratio is "not a measure of the cost of equity capital" is one on which reasonable economists have differed. Rather than make the technical case that the M/B ratio is a good proxy for the cost of equity capital, let me note a misreading that has led Hass astray: He says that "the principal determinant of regulatory climate Navarro cites is the rate of return allowed by the PUC." In fact, I named five other criteria that help determine regulatory climate.

Hass then argues, however, that the allowed rate of return is "a proxy for anticipated future allowed rates of return," so that it is "not surprising" that the M/B ratio correlates with regulatory climate. Since this leap in logic is not based on what was in my article, I find his conclusion ("Thus the M/B ratio is *not* a measure of the cost of equity capital") to be more confusing than persuasive.

I totally agree with Hass that an unfavorable regulatory climate raises risk and therefore the cost of capital through risk premiums. That is precisely why utilities with "unfavorable" regulatory climates tend to have lower bond ratings.

Turning to Costello, I sympathize with his defense of PUC members, who after all sit on the hot seat of public opinion; and I am only slightly less fearful than he of federal intervention to solve utilities' financial problems. On the other hand, I do not consider displacing oil to be "ipso facto in the national interest." When oil passed $30 per barrel in 1979, however, it became economic to displace fully two-thirds of our base load oil capacity. *No* "serious distortions would arise" from doing that; indeed, ratepayers would benefit.

His concern that allowing utilities to use a future test year might let them inflate costs ignores a primary role of PUC members such as himself—monitoring costs. It is easy to return any overcharge to consumers at the end of the rate year. The alternative, using a historic test year, is partly to blame for the large gap between the allowed and the realized rate of return of many utilities.

Finally, I simply disagree with his view that financial problems have played less of a role than sluggish demand in curbing new power plants. In many oil-dependent areas it is cheaper to build new capacity than to continue operating oil plants even if there is *zero* load growth. Many utilities, to be sure, are forgoing new plants in the *name* of conservation, but the underlying problem is financial. ■

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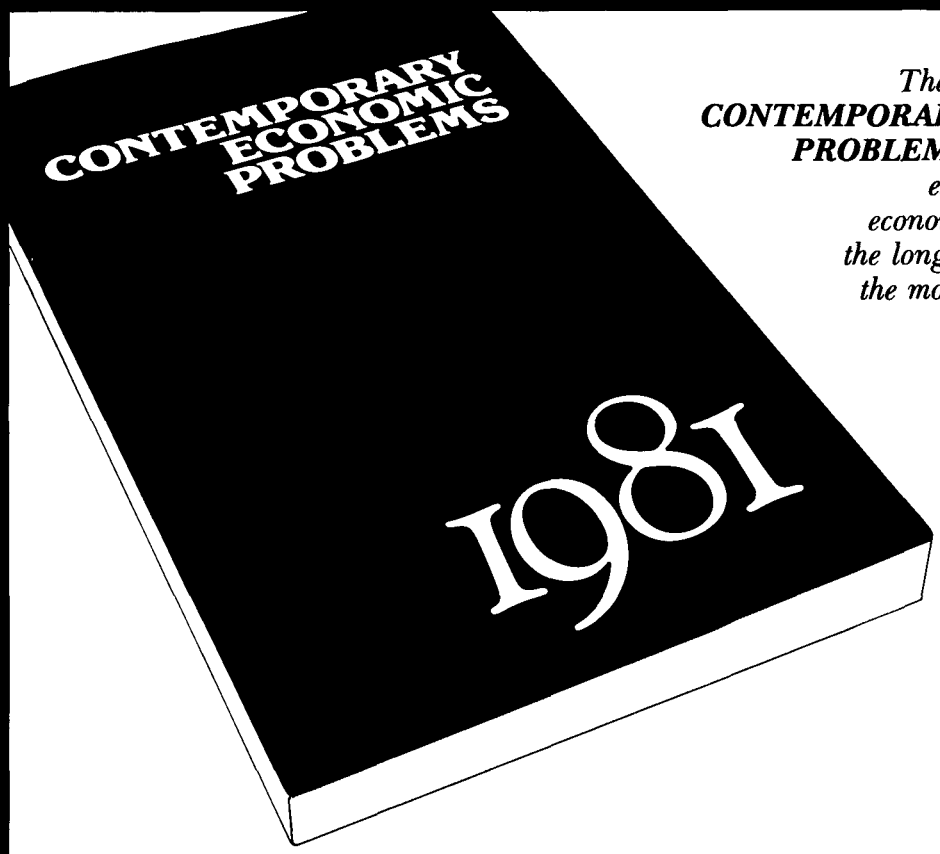

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